Advisory Panel on
Canada's System of
International Taxation

FINAL REPORT

Enhancing Canada's International Tax Advantage

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December 2008

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December 2008

The Honourable James M. Flaherty, P.C., M.P.
Minister of Finance
House of Commons
Ottawa, Ontario

Dear Minister,

As members of the Advisory Panel on Canada's System of International Taxation, we are pleased to submit our final report and recommendations.

Over the past year, we have studied Canada's international tax system and consulted with Canadians on how it could be improved. We believe our recommendations will help guide the development of a simpler, fairer, more efficient system that improves the competitiveness of Canadian businesses internationally and attracts new foreign investment to Canada.

We would like to thank the many Canadians and others who engaged in this debate with enthusiasm and insight, and we acknowledge the assistance and support of public servants from the Department of Finance and the Canada Revenue Agency.

We thank you for the opportunity to contribute our views on enhancing Canada's international tax advantage.

Yours sincerely,

Peter C. Godsoe, OC
Chair

Kevin J. Dancey, FCA
Vice Chair

James Barton Love, QC

Finn Poschmann

Nick Pantaleo, FCA

Cathy Williams

Guy Saint-Pierre, CC

Members of the Advisory Panel on Canada's System of International Taxation

- Peter C. Godsoe, OC, Chair
- Kevin J. Dancey, FCA, Vice Chair
- James Barton Love, QC
- Nick Pantaleo, FCA
- Finn Poschmann
- Guy Saint-Pierre, CC
- Cathy Williams

For biographical information about the Panel members, see Appendix D.

Acknowledgments

This report is the product of the collective efforts and commitment of all those who worked with and assisted the Panel. The members of the Panel would like to acknowledge and thank the following people:

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The Panel thanks the organizations and people involved in coordinating our cross-country consultation meetings and providing expert advice. We also thank representatives of the federal government, who provided information and assistance, and the researchers, who provided insight and analysis to support us in our work.

Note to reader

In writing this report, the Panel has aimed to use plain language to express our views on a highly complex topic. Readers should be aware that the descriptions of international tax rules, business structures and transactions in this report have been simplified. Unless otherwise stated, statutory references in this report are to the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act").

Table of Contents

1. Introduction

1.1 Canada's system of international taxation is important to our country's competitiveness. At the global level, competitiveness is crucial to attracting high-value activities, spurring innovation, and creating skilled jobs. Establishing Canada's competitive advantage is part of the Government of Canada's strategic policy, as set out in *Advantage Canada*,[1] its long-term economic plan. Improving the international tax system will enhance Canada's advantage to the benefit of all Canadians.

1.2 In its domestic tax policy, the government has taken action to improve the competitiveness of Canadian businesses. Canada's domestic corporate tax rate is a key factor affecting the ability of Canadian businesses to expand abroad. The government's goal of attaining the lowest effective tax rate on new business investment in the G7 supports our country's international competitiveness.

1.3 In its international tax policy, Canada must ensure that its taxation system keeps pace with global trends to support business investment abroad and to attract foreign investment. For this reason, the Minister of Finance established the Advisory Panel on Canada's System of International Taxation in November 2007.

Our mandate

1.4 The Panel's mandate was to recommend ways to improve the competitiveness, efficiency and fairness of Canada's system of international taxation, minimize compliance costs, and facilitate administration and enforcement by the Canada Revenue Agency (CRA). The Panel focused primarily on how Canada's international tax rules affect Canadian businesses investing in foreign markets and how the rules affect foreign businesses investing in Canada.

1.5 Members of the Panel were drawn from the Canadian business community, professional tax advisory firms, and the tax policy research field. The chair and vice chair of the Panel are Peter C. Godsoe, OC, and Kevin J. Dancey, FCA. Also on the Panel are James Barton Love, QC, Nick Pantaleo, FCA, Finn Poschmann, Guy Saint-Pierre, CC, and Cathy Williams.

1 Department of Finance Canada, *Advantage Canada: Building a Strong Economy for Canadians* (Ottawa: Public Works and Government Services Canada, 2006).

Our approach

1.6 The Panel approached our mandate with the aim of supporting *Advantage Canada*. The Panel also monitored the work of Canada's Competition Policy Review Panel, which had a complementary mandate and issued its final report, *Compete to Win*, in June 2008. The Panel agrees with that report's proposition that "raising Canada's overall economic performance through greater competition will provide Canadians with a higher standard of living" and that in "the new world economy, Canada must be ready to keep pace with change and develop a global mindset that is open to two-way trade, investment and talent."[2]

1.7 In developing our recommendations, the Panel sought to understand the current state of Canada's system of international taxation, how it affects businesses, and how it compares with the international tax systems of other countries around the world.

1.8 Our discussion document, *Enhancing Canada's International Tax Advantage*,[3] set the context for consultation with a series of questions and an open call for submissions. In response, we received submissions from businesses, tax advisory services firms, professional associations, industry groups and individuals.

1.9 From April to July 2008, we conducted numerous consultations and round tables, engaging in informal discussions with many business groups, industry associations, economists and tax advisors across Canada to better understand their experience with Canada's system of international taxation and their ideas on how to improve it. We also met with officials from the CRA and the Department of Finance.

1.10 The Panel conducted a program of research to supplement our consultations and deliberations. This research included a review of the tax systems of Canada's major competitors in order to benchmark Canada's system against international norms. We also interviewed officials with the tax authorities of the United States, the United Kingdom and other countries.

1.11 Our views and recommendations have been shaped by the submissions we received, by our deliberations, consultations and research, and by our experiences.

1.12 The predominant view formed by the Panel is that the Canadian international tax system is a good one that has served Canada well. As such, the Panel's recommendations seek not to reform but rather to improve our existing system.

2 Competition Policy Review Panel, *Compete to Win* (Ottawa: Public Works and Government Services Canada, June 2008), at p. 1 and p. 13.

3 Advisory Panel on Canada's System of International Taxation, *Enhancing Canada's International Tax Advantage: A Consultation Paper Issued by the Advisory Panel on Canada's System of International Taxation* (Ottawa: April 2008).

1.13 Although the Panel's mandate did not specify that our recommendations should be fiscally neutral, the Panel considered how they could affect Canada's tax revenues. In considering the fiscal impact of our proposals, the Panel recognized the importance of promoting competitiveness and the responsibility of sustaining Canada's tax revenues, especially in light of the current economic climate. We believe the consequences of our recommendations, taken together, should not result in any net fiscal cost to the government.

1.14 The Panel's goal is to offer pragmatic, balanced and actionable advice to the Minister of Finance toward improving Canada's international tax system for the benefit of our country.

2. Our Current Environment

Introduction

2.1 Tax policy must be developed with an understanding of how the economy operates and what motivates people and businesses. Maintaining this knowledge becomes more challenging as enterprises grow more sophisticated, businesses continue to expand globally, and national economies become more interconnected.

2.2 The global landscape is changing quickly. Current events show how swiftly capital markets can change and influence industrial and commercial activity, and how adaptable Canadian companies need to be in response. Within the past 16 months, the ways in which financial market participants evaluate credit, liquidity and market risk have shifted dramatically amid unprecedented intervention by governments and central banks. The Panel acknowledges that the current situation is worrisome and that similar events could occur in the future. With this in mind, we have taken a long-term view in developing our recommendations.

2.3 As a relatively small trading nation, Canada has traditionally pursued an open economy. Canada's system of international taxation has historically reflected this pursuit.

2.4 This chapter highlights some of the important elements influencing the development of international tax policy in Canada.

Tax policy and cross-border investment

2.5 Domestic tax rates play an important role for Canadian companies investing abroad and in the overall attractiveness of Canada as a place to invest. As noted in paragraph 1.2, in its domestic tax policy, the Canadian government has taken action to improve the competitiveness of Canadian businesses with scheduled reductions to Canada's domestic corporate tax rate. Currently, the combined federal-provincial corporate tax rate is scheduled to decrease from about 31.9 percent at the start of 2008 to 25 percent by 2012 (assuming a 10 percent provincial rate in 2012).

2.6 In our consultation paper, the Panel noted that foreign competitors of Canadian businesses are growing in strength and number, aided in many cases by the tax policies of their home countries. Some countries have already reduced their corporate taxes in their efforts to compete for capital, jobs and growth. For example, the average corporate tax rate of member countries of the Organisation for Economic Co-operation and Development (OECD) has dropped from 34.1 percent in 2000 to 26.7 percent in 2008.[4]

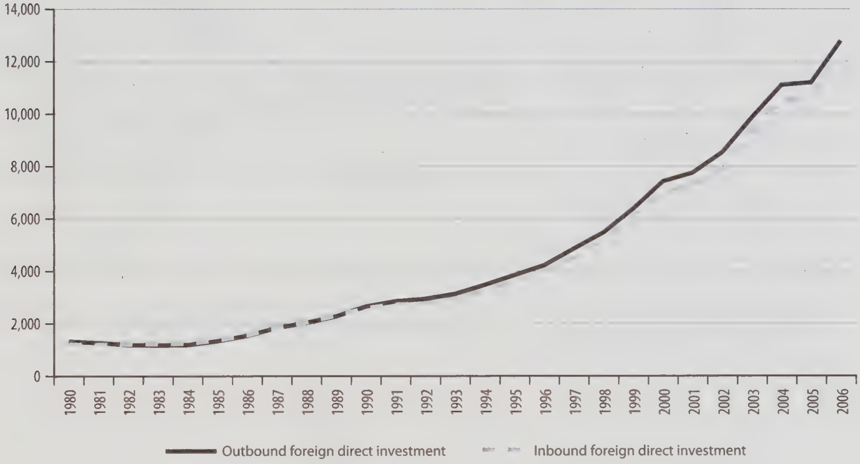
4 KPMG International, *KPMG's Corporate and Indirect Tax Rate Survey 2008* (September 2008), at p. 15.

2.7 Foreign direct investment (FDI) has become a central feature of the world's economy, and its importance for Canada and for other national economies has grown significantly in recent years.

2.8 Since 1980, the worldwide stock of FDI has increased substantially. Figure 2.1 shows how world stocks of outbound and inbound direct investment evolved between 1980 and 2006. Both stocks grew by about 900 percent in real terms over that period and are in excess of USD$12 trillion.

Figure 2.1

Stock of Total World Outbound and Inbound Direct Investment 1980–2006 (billions of constant 2007 U.S. dollars)

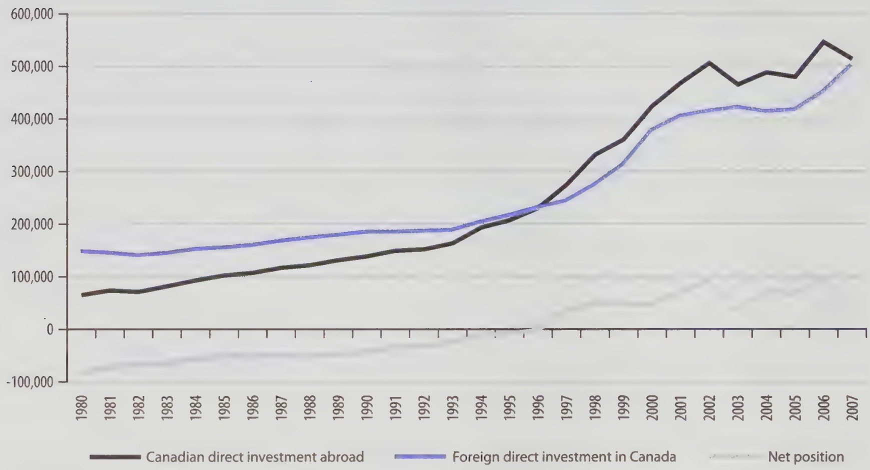


Source: UNCTAD, Foreign Direct Investment Online Database.

2.9 Canadian direct investment abroad and foreign direct investment in Canada have grown significantly since 1980 and both now exceed $500 billion (see Figure 2.2). Canada's direct investment abroad has exceeded inbound investment since 1997.

Figure 2.2

Stock of Direct Investment by Canadians Abroad and by Foreigners in Canada 1980–2007 (millions of 2007 constant Canadian dollars)



Source: Statistics Canada, CANSIM Table 376-0037.

Benefits of foreign inbound and outbound direct investment to Canada

2.10 The rising importance of FDI for the Canadian economy is a positive development.[5] The Competition Policy Review Panel made the following observation:

> With our small domestic market, Canada must look outward. To that end, the (Competition) Panel has been mandated to investigate how best to encourage outward investment by Canadian firms.
>
> ...(T)he government has a significant role to play in establishing the conditions that will assure Canada's position as an attractive destination for investment, both by Canadians and those from abroad.[6]

Outbound direct investment

2.11 Outbound direct investment is associated with efficiency gains and greater productivity. Such benefits may arise from the ability to achieve scale economies and greater specialization, set up global supply chains, and access foreign technologies.[7]

2.12 Because of these efficiency gains, outbound direct investment can generate positive benefits for the Canadian economy. Canadian companies with international operations undertake high-value-added headquarters activities in Canada. Their domestic suppliers may also benefit through indirect technology transfers.[8]

"As a country with a wealth of resources and ideas, but a relatively small market and consumer base, our prosperity is built on our openness to international trade and investment."

— *Foreign Affairs and International Trade Canada web page, "Seizing Global Advantage: A Global Commerce Strategy for Securing Canada's Growth and Prosperity" (www.international.gc.ca, February 15, 2008).*

5 For general surveys of the literature on the benefits of foreign direct investment for Canada, see John R. Baldwin and Guy Gellatly, *Multinationals in Canada: An Overview of Research at Statistics Canada* (Ottawa: Statistics Canada, 2007); and Yvan Guillemette and Jack M. Mintz, *A Capital Story: Exploding the Myths around Foreign Investments in Canada*, C.D. Howe Institute Commentary no. 201 (Toronto: C.D. Howe Institute, 2004). See also Conference Board of Canada, *The Benefits of Foreign Direct Investment — How Investment in Both Directions Drives Our Economy* (Ottawa: Conference Board of Canada, 2006).

6 Competition Policy Review Panel, *Sharpening Canada's Competitive Edge* (Ottawa: Public Works and Government Services Canada, October 2007), at p. 3.

7 Someshwar Rao, Marc Legault and Ashfaq Ahmad, "Canadian-Based Multinationals: An Analysis of Activities and Performance", in Steven Globerman (ed.), *Canadian-Based Multinationals*, Industry Canada Research Series, vol. 4 (University of Calgary Press: 1994), at pp. 63-123; John R. Baldwin and Wulong Gu, *Multinationals, Foreign Ownership and Productivity Growth in Canadian Manufacturing* (Ottawa: Statistics Canada, December 2005).

8 Guillemette and Mintz, op. cit., at p. 19.

Inbound direct investment

2.13 Investment by foreign businesses in Canada does not displace domestic economic activity. In fact, it adds to the stock of capital invested in Canada, resulting in faster growth, greater employment, higher living standards, and additional tax revenues for governments in Canada.[9] Inbound direct investment can encourage more competition in Canadian markets, leading to greater productivity.

2.14 Inbound direct investment is also a channel through which Canada can gain access to new foreign technologies.[10] By interacting with foreign-owned companies in Canada, domestic companies can benefit from the transfer of these new technologies and knowledge. In addition, foreign-owned Canadian companies perform a significant amount of research and development (R&D) in Canada.[11]

"Fears about FDI, rooted in protectionist thinking from the 1970s, do not reflect the new realities of global trade and investment. The idea that foreign-controlled companies operating in Canada will turn us into a 'branch plant' economy is entirely outmoded. With globalization and open markets, production processes have been decentralized and disaggregated among different locations. Supply chains now criss-cross borders. Canada's challenge is to ensure that we maintain and enhance our position within global supply chains — and this, in turn, requires attracting inward foreign direct investment and investing heavily abroad."

— *The Conference Board of Canada,* The Benefits of Foreign Direct Investment — How Investment in Both Directions Drives Our Economy, *March 2006, at p. 1.*

An increasingly competitive international environment

2.15 The competition that Canada faces now for investment within and outside Canada is expected to accelerate. New competitors are emerging, notably from developing economies. Some of these new competitors are aggressively seeking capital, while others have substantial amounts of capital to invest. Canadian businesses need to be able to compete with them for investment on both the outbound and inbound fronts.

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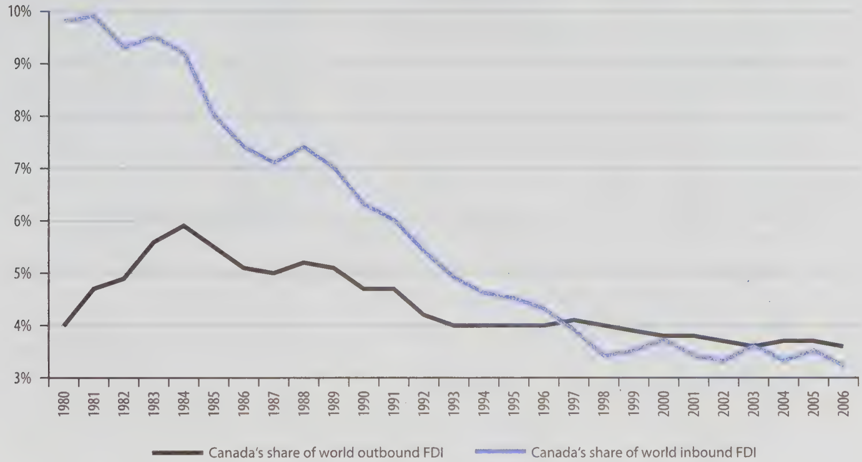
9 John Ries, "Foreign Investment, Trade and Industrial Performance: Review of Recent Literature", in Someshwar Rao and Andrew Sharpe (eds.), *Productivity Issues in Canada*, Industry Canada Research Series, vol. 10, (University of Calgary Press: 2002), at pp. 571-594; Walid Hejazi and Peter Pauly, *Foreign Direct Investment and Domestic Capital Formation*, Industry Canada Research Publications Program, working paper no. 36 (2002); John R. Baldwin, *The Dynamics of the Industrial Competition: A North American Perspective* (Cambridge University Press: 1995).

10 Someshwar Rao and Jianmin Tang, *Contribution of Transnational Corporations to Canada's Competitiveness* (Industry Canada, mimeo, 2004); Alla Lileeva, *The Benefits to Domestically-Controlled Plants from Inward Direct Investment — The Role of Vertical Linkages* (Ottawa: Statistics Canada, April 2006); John R. Baldwin and David Sabourin, *The Effect of Changing Technology Use on Plant Performance in the Canadian Manufacturing Sector* (Ottawa: Statistics Canada, 2004); Surenda Gera, Wulong Gu and Frank Lee, *Foreign Direct Investment and Productivity Growth: The Canadian Host-Country Experience* (Industry Canada Research Publications Program, working paper no. 30, 1999).

11 John R. Baldwin and Petr Hanel, *Multinationals and the Canadian Innovation Process* (Ottawa: Statistics Canada, June 2000); J.A.D. Holbrook and R.J. Squires, "Firm-Level Analysis of Determinants of Canadian Industrial R&D Performance", *Science and Public Policy*, vol. 23(6) (December 1996), at pp. 369-374; Someshwar Rao and Jianmin Tang, *R&D Propensity and Productivity Performance of Foreign-Controlled Firms in Canada* (Industry Canada Research Publications Program, working paper no. 33, 2001).

Figure 2.3

Canada's Share of Total World Stock of Outbound and Inbound Direct Investment, 1980–2006



Source: UNCTAD, Foreign Direct Investment Online Database.

2.16 Canada's share of the total world stock of inbound and outbound foreign direct investment has been decreasing for a number of years (Figure 2.3). On the inbound side, foreign direct investment decreased from nearly 10 percent of the world stock of FDI in the early 1980s to 3.2 percent in 2006. On the outbound side, Canadian direct investment abroad fell from a high of 5.9 percent in 1984 to 3.6 percent in 2006. Canada's average annual growth rate in the stock of outbound direct investment from 1990–2006 of just over 10 percent is the second-lowest among G7 countries.[12]

> "Canada's share of outward global FDI has slipped relative to OECD countries such as France, Germany, the UK, Sweden, and Australia. Canadian firms continue to face real competitive challenges as they seek to expand their market presence globally."
>
> — *Submission of the Conference Board of Canada, at p. 3.*

12 Calculations based on data from UNCTAD, Foreign Direct Investment Online Database.

Looking forward

2.17 The above data demonstrate that Canada's relative share of inbound and outbound investment has fallen. There are many possible explanations for this decline, including new competition from emerging economies, and most of these explanations have little to do with tax. To the Panel, however, Canada's declining FDI share reinforces the competitive nature of the world economy and highlights the need to consider carefully any international tax changes that impede the ability of Canadian businesses to compete. Other countries are moving in a similar direction; for example, New Zealand has acknowledged that one of the key reasons its outbound direct investment could be hindered is its uncompetitive outbound international tax rules.[13]

"(W)hile the current system is conceptually attractive, its lack of conformity with international taxing norms puts pressure on the New Zealand tax system. There is a concern that it inhibits the internationalisation of New Zealand business. The current system risks inducing New Zealand businesses with significant international operations to migrate, and it could inhibit the development of multinational enterprises based in New Zealand."

— *New Zealand Inland Revenue Department,* New Zealand's International Tax Review — A Direction for Change, *December 2006, at p. 14.*

2.18 In summary, inbound investment and outbound investment are important to the Canadian economy, and the competition for this investment is increasing. The principles and the specific recommendations that follow attempt to strike a balance between protecting the Canadian tax base and ensuring that Canada's international tax system does not impede cross-border business investment.

13 New Zealand, Inland Revenue Department, Policy Advice Division, *New Zealand's International Tax Review — A Direction for Change* (Wellington: Inland Revenue Department, December 2006), at p. 16.

3. Principles for Guiding Canada's International Tax Policy

Introduction

3.1 In setting any government policy, a clear and sound set of principles is invaluable. Principles offer guidance now and in the future in setting tax policy, and they can point the way when making decisions among different alternatives.

3.2 In this chapter, the Panel has distilled what it believes should be the principles that underpin Canada's system of international taxation. In developing our recommendations, the Panel took direction from these principles.

3.3 The Panel acknowledges that setting international tax policy entails trade-offs and practical constraints. In the Panel's view, Canadian international tax policy makers should be guided by the following principles:

1. Canada's international tax system for Canadian business investment abroad should be competitive when compared with the tax systems of our major trading partners.
2. Canada's international tax system should seek to treat foreign investors in a way that is similar to domestic investors, while ensuring that Canadian-source income is properly measured and taxed.
3. Canada's international tax system should include appropriate safeguards to protect the Canadian tax base.
4. Canada's international tax rules should be straightforward to understand, comply with, administer and enforce, to the benefit of both taxpayers and the CRA.
5. Full consultation should precede any significant change to Canada's international tax system.
6. Canada's international tax system should be benchmarked regularly against the tax systems of our major trading partners.

3.4 We believe that an international tax system that is consistent with these principles will be competitive, efficient and fair, and deliver predictable and certain results. The system will also be less costly for all businesses to comply with[14] and easier for the CRA to administer and enforce.

14 For example, the Canadian Federation for Independent Business estimates that the cost to Canadian businesses of tax compliance is about $12.6 billion annually. See Lucie Charron, George Chow and Janine Halbesman, "The Hidden Tax Burden: A business perspective on the cost of complying with taxes", Canadian Federation of Independent Business Research Series: Report I (August 2008), at p. *iv*. Also see PricewaterhouseCoopers LLP, *Total Tax Contribution, Canada's tax regime: complexity and competitiveness* (May 2008), at p. 23.

Competitive tax system for Canadians investing abroad

3.5 The competitiveness of Canada's outbound tax system has been a concern of the government since the system was put in place in the mid-1970s. Many features of the existing system were adopted with the goal of fostering the competitiveness of Canadian companies investing in foreign markets. In 1992, former Department of Finance Deputy Minister David Dodge made the following observation:

> Canada's approach to taxing foreign-source income…falls squarely within the international norms. What it seeks to do is to ensure that Canadian-based multinationals remain viable and competitive with those based in other countries…. At the same time, the specific anti-avoidance rules…seek to ensure the system is not open to abuse.[15]

3.6 To the Panel, this statement reflects how the system was viewed from its inception and the key policy goals needed to achieve a competitive tax system. The statement acknowledges that the system should be benchmarked globally and should protect the Canadian tax base.

3.7 In the Panel's view, the overriding principle guiding Canada's taxation of outbound direct investment should be to ensure that the Canadian tax treatment of foreign-source business income does not disadvantage Canadian businesses investing abroad when compared with their foreign competitors. Achieving this goal can be accomplished, in part, by not exposing Canadian businesses to costs in relation to their foreign business income that their foreign competitors are not required to incur.

3.8 Having companies that are internationally competitive is particularly crucial for Canada. As discussed in Chapter 2, access to foreign markets is key for Canadian firms to grow and achieve economies of scale. Because the Canadian market is relatively small, Canadian companies often need to engage in cross-border trade sooner than other companies that are based in countries with larger domestic markets.

> "Governments must … evaluate policy, not in a domestic context, but in a global one. When examining legislation, setting policy and establishing regulations, governments need to consider how this positions Canada against our competitors and in the context of Canada's links to the U.S. economy. It also means establishing a process where we continually review and refine our policies to reflect a fast evolving world and changing circumstances. Competitiveness begins at home, but it is measured internationally."
>
> — *Competition Policy Review Panel,* Compete to Win, *June 2008, at p. 103.*

15 House of Commons, Standing Committee on Public Accounts, Minutes of Proceedings and Evidence, no. 37, December 8, 1992.

3.9 Economists have identified three economic principles as possible guides to setting international tax policy. These principles are described in the accompanying box. Nevertheless, the Panel has highlighted competitiveness as a predominant principle. While competitiveness is not a well defined economic principle in the context of international taxation, the Panel firmly believes that it should be a fundamental consideration in developing Canadian tax policy. The Panel also believes that a focus on maintaining a globally competitive tax system is appropriate to a small, open economy such as Canada's.

Economic Approaches to the Taxation of Foreign Direct Investment Income

Besides being fair and simple, a good tax system should be economically efficient: it should impose the least possible burden on the economy while generating its target revenue.

FDI refers to investments that give the investor a significant interest in the foreign entity, and thus influence over the management of its business activities. A tax imposed on income from FDI not only affects the competitiveness of multinationals but also may distort the investment and saving decisions of taxpayers and may affect the pattern of ownership of business assets among corporations. Economists have identified three possible objectives that countries might pursue to ensure neutrality in designing their systems for taxing income from FDI:

- *"Capital Export Neutrality" (CEN): Where CEN is the chosen objective, a tax system is designed to be neutral regarding resident investor preference for investment at home or abroad, so the more profitable investments (on a pre-tax basis) are made first.*
- *"Capital Import Neutrality" (CIN): Where CIN is chosen, investors from different countries face the same level of tax when doing business in a given country, so there is neutrality with respect to the investment decisions made by residents of different countries.*
- *"Capital Ownership Neutrality" (CON): If CON is the objective, a tax system is designed to be neutral as to which corporations own and exploit capital assets, so the corporations that exploit a given asset most efficiently are willing to pay the most to own that asset.*

Different countries, however, tax income from FDI at different rates, so fulfilling the three neutrality standards with a single set of tax rules is impossible. For example, taxing foreign business income on an accrual basis with a credit for foreign taxes paid on that income would conform with the CEN standard but not with CIN or CON. Conversely, providing an exemption for foreign business income could conform with CIN and CON but not with CEN, as it could create a bias in favour of foreign investment.

Of course, countries will consider many other factors beyond neutrality in designing their tax systems, including competitiveness.

3.10 While striving to meet its other objectives, the outbound international tax system needs to protect the Canadian tax base. A competitive international tax system includes robust rules for taxing foreign passive income. Rules to properly measure and tax transactions that involve Canadians' selling or buying goods and services to or from foreign persons are also critical. These rules also should be benchmarked against similar regimes in other countries.

3.11 Some observers worry that a competitive outbound tax system will cause a preference for foreign investment over domestic investment and lead to a loss of jobs within Canada. The government itself expressed this concern when Canada's outbound international tax system was being developed. The White Paper of 1969, in which the government presented its proposals that led to the 1972 tax reform, commented as follows:

> For the foreseeable future Canada's capital requirements will continue to exceed available domestic savings.... In these circumstances it would clearly be inappropriate to encourage the export of investment capital needed domestically.
>
> On the other hand, Canadian business is often required to go abroad to seek foreign sources of supply and to develop foreign markets. Going international is frequently necessary to enable Canadian companies to achieve the economies of scale which are otherwise denied them by the relatively small size of the Canadian domestic market. Such companies would find it hard to compete on the international scene if they were subject to more onerous taxes than those which apply to their competitors....[16]

3.12 Despite these concerns, existing Canadian studies suggest that Canadian direct investment abroad does not significantly affect domestic capital formation.[17] Rather than shifting capital abroad, recent international evidence (based mainly on firm-level data) indicates that outbound direct investment more likely has a beneficial effect on the domestic stock of capital.[18]

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16 Department of Finance Canada, *Proposals for Tax Reform* (Ottawa: Queen's Printer, 1969), at paragraphs 6.8-6.9.

17 Someshwar Rao, Marc Legault and Ashfaq Ahmad, "Canadian-Based Multinationals: An Analysis of Activities and Performance", in Steven Globerman (ed.), op. cit., at pp. 63-123; Walid Hejazi and Peter Pauly, *Foreign Direct Investment and Capital Formation* Industry Canada Research Publications Program, working paper no. 36 (2002); Walid Hejazi and Peter Pauly, "Motivations for FDI and Domestic Capital Formation", *Journal of International Business Studies*, vol. 34 (2003), at pp. 282-289.

18 Mihir A. Desai, C. Fritz Foley and James R. Hines Jr., "Foreign Direct Investment and the Domestic Capital Stock", *American Economic Review*, vol. 95(2) (May 2005), at pp. 33-38; Mihir A. Desai, C. Fritz Foley and James R. Hines Jr., *Foreign Direct Investment and Domestic Economic Activity*, National Bureau of Economic Research working paper no. 11717 (October 2005); Isabel Faeth, *Consequences of FDI Australia — Causal Links Between FDI, Domestic Investment, Economic Growth and Trade*, Australian National University, Department of Economics Research Paper 977 (2006).

3.13 A more common worry among some Canadians is how Canadian direct investment abroad affects Canadian employment. The Panel found no clear evidence that direct investment abroad leads to an export of jobs or increases unemployment in a capital-exporting country like Canada.[19] Rather, outbound direct investment appears to move employment away from low-value-added jobs and toward higher-value-added work.[20]

3.14 A 2004 report by the C.D. Howe Institute[21] summarizes the state of research on these issues:

> While the decision to outsource certain activities is quite independent of ownership, there is a commonly held view that Canadian direct investment abroad (CDIA) may transfer production facilities from Canada to foreign locations and reduce Canadian employment levels. As Gunderson and Verma (1994) point out, however, this argument comes back to the classic "lump of labour fallacy", according to which there is a fixed number of jobs in an economy so that investing in another country becomes the equivalent of exporting jobs. This concern rests largely on unstated premises that CDIA substitutes for exports and domestic capital formation. As shown, these premises are false.
>
> In a long-term perspective, the employment-loss argument loses much of its force. In the long run, CDIA generates investment income, as well as contributing to exports and increased efficiency within the home economy. In fact, direct investment abroad leads to a change in the employment structure of the home country, away from low-value-added employment and toward higher-value-added work. Higher-value-added jobs reflect Canada's comparative advantage in knowledge-intensive occupations....

3.15 Accordingly, the Panel believes the risk that a competitive outbound tax system will result in a loss of economic activity in Canada is less than the risk of losing business because our system is not competitive. Other countries acknowledge that systems that deviate too much from international norms carry a steep cost. For example, a number of companies moved their parent corporation out of the United States in order to achieve tax savings, notably with respect to their foreign business income.[22] Following a series of corporate

> "British businesses and the Government will ... look at the long-term challenges facing the UK tax system and ensure competitiveness remains at the heart of any future reforms .... In his speech, the Chancellor said ...'Tax is one element of the strong business environment which makes the UK competitive at a global level.'"
>
> — *HM Treasury press release, April 29, 2008.*

19 Morley Gunderson and Savita Verma, "Labour-Market Implications of Outward Foreign Direct Investment", in Steven Globerman (ed.), op. cit., at pp. 179-213.

20 Margit Molnar, Nigel Pain and Daria Taglioni, *The Internationalisation of Production, International Outsourcing and Employment in the OECD*, OECD Economics Department working paper no. 561, July 2007; P.S. Andersen and P. Hainaut, *Foreign Direct Investment and Employment in the Industrial Countries*, Bank for International Settlements working paper no. 61 (1998).

21 Yvan Guillemette and Jack Mintz, op. cit., at pp. 18-20.

22 See Mihir A. Desai and James R. Hines Jr., "Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions", *National Tax Journal*, vol. 55(3), September 2002, at pp. 409-440. See also New York State Bar Association Tax Section, "Outbound Inversion Transactions", *Tax Notes*, July 1, 2002, at pp. 127-149, and U.S. Department of the Treasury, *Corporate Inversion Transactions: Tax Policy Implications* (May 2002).

migrations out of the United Kingdom,[23] the Chancellor of the Exchequer announced a new project to review the UK taxation system in April 2008, saying that competitiveness would be a central focus of any changes arising from the review.[24]

3.16 These examples show the importance for Canada of benchmarking its outbound tax system with the systems in place in other developed countries to ensure Canada's system does not disadvantage Canadian businesses. Of course, achieving a competitive outbound tax system does not mean Canada should take part in an unsustainable and potentially harmful race to the bottom with other countries. A competitive tax policy for outbound investment does not need to place the Canadian tax base at risk, and robust rules to tax foreign passive and other mobile income are important. In the Panel's view, a tax policy that is attuned to competitiveness is one that reflects strategic choices regarding key design features.

Level playing field for domestic business activity

3.17 Foreign direct investment brings significant benefits to the Canadian economy. While competitiveness is an important feature of an outbound international tax system, domestic competition is also important to Canada's inbound regime. Recognizing the importance of domestic competition, the government has taken action to ensure Canada remains an attractive destination for foreign investors. This action includes maintaining the scheduled federal corporate income tax reductions.

> "(B)eing an attractive destination for skilled immigrants and foreign investment will be a critical success factor for developed countries."
>
> — *Competition Policy Review Panel,* Compete to Win, *at p. 8.*

3.18 Canada's tax treatment of inbound direct investment should contribute to the policy of attracting foreign investment. At the same time, Canada's inbound tax system should, to the extent appropriate, seek to treat foreign investors and domestic investors similarly in taxing their income from Canadian sources.

3.19 A level playing field for the taxation of Canadian-source income is a key concern of Canadian businesses. Foreign entities doing business in our country should pay Canadian tax on what is properly considered Canadian-source income.

3.20 Although no playing field can ever be perfectly level, the Panel believes that creating the conditions to ensure that Canadian and foreign businesses investing in Canada compete on similar footing should be a key consideration of the government in setting Canada's tax policies regarding inbound direct investment.

23 In the past year, four high-profile UK companies have announced they are relocating their tax domicile to the Republic of Ireland (Shire plc, United Business Media plc, Henderson Group plc, and most recently WPP Group). In an October 6, 2008 interview, Martin Sorrell, chief executive of the WPP Group, told the *Financial Times* that more UK companies might decide to relocate their tax domicile if the UK government did not improve the competitiveness of its corporate tax regime (*Tax Notes International*, October 6, 2008, at p. 7 and October 13, 2008, at p. 116).

24 HM Treasury news release, "Chancellor announces new business-government forum on tax" (April 29, 2008).

Protecting the tax base

3.21 Canada's system of international taxation should include appropriate rules to properly measure and tax Canadian-source income. The Panel believes such rules should include robust anti-deferral regimes for foreign passive income, effective transfer pricing rules, and targeted anti-avoidance rules.

Straightforward tax rules

3.22 The tax system should be designed with a view to minimizing the compliance cost of taxpayers and facilitating its administration and enforcement by the CRA. The ability to achieve this objective is determined largely by the complexity of the tax laws.

3.23 International taxation is a complex subject, and some level of complexity in the tax rules is inevitable. Nonetheless, the Panel believes complexity in tax rules should be avoided where possible, provided tax policy objectives are not sacrificed. The CRA and businesses need unambiguous, readily understandable rules. The CRA also needs workable solutions for assessing data to determine whether the rules have been met.

3.24 General rules with broad application should be plainly drafted so that businesses, their advisors and the CRA can readily understand how to interpret and apply them. Particular areas of concern should be addressed with additional guidance from the CRA or anti-avoidance rules that target the problem directly without affecting a wider range of taxpayers than absolutely necessary. Though clear-cut rules can result in rough justice for taxpayers or the government in some cases, such instances must be weighed against the efficiencies and savings that greater simplicity will bring.

3.25 Predictability regarding future tax changes is just as important. New tax rules should be introduced and implemented in a timely fashion so that businesses can make decisions with a clear grasp of their tax implications.

Open consultation

3.26 Canada's tax legislative process should be as open and transparent as possible to increase certainty for taxpayers while bearing in mind the potential market implications of budget proposals or other new measures. To increase certainty and avoid unintended consequences for Canadian businesses, consultations should be held regarding possible tax policy changes, with a reasonable period of time allowed for study and comment on the potential impact of a proposed rule before it takes effect.

Regular benchmarking

127 In our consultation paper, the Panel noted that Canadian businesses face increased international competition and that the tax policies of other countries are part of the reason for this increase. Many countries are considering or are already changing their tax systems to compete for capital, jobs and growth. Canada's tax policy must anticipate continuous change in the global environment and retain the flexibility to adapt accordingly. Regular benchmarking can help ensure Canada's system of international taxation stays in step with or ahead of international norms.

Implementing the principles

128 Canada's international tax system, and its tax system generally, is largely dependent on self-assessment. Should self-assessment break down, the result would be an ineffective and inefficient tax system that would benefit no one.

129 Achieving an effective self-assessment system requires a culture of mutual responsibility and cooperation among businesses, their advisors and government.

> *Responsibility of businesses and their advisors:* The Panel understands that every business will seek to organize its affairs in a way that minimizes the tax it pays. This long-standing principle should continue. However, there is a limit to reasonable tax minimization, and businesses and their advisors have a duty to respect the object and spirit of the tax law and to understand the legitimate need for government to protect Canada's tax base.
>
> *Responsibility of government:* Government must accept that most businesses seek to comply with the letter and spirit of the law and do not practise inappropriate tax minimization. An overly negative view from government would put at risk the goal of achieving a competitive, efficient and fair tax system.

130 To call for businesses to be reasonable in their tax planning and for tax administrators to be less suspicious may be perceived as naïve. The Panel believes that mutual responsibility and cooperation will help achieve real efficiency and simplicity within the tax system. The alternative would lead to more rules, aggressive tax planning, suspicion and litigation. The Panel believes the Canadian tax system could be made better. Applying the above principles, in a spirit of cooperation and mutual respect, would offer Canada an opportunity to distinguish itself from other countries and enhance its international tax advantage.

Our recommendations

1.31 The body of this report includes an integrated package of specific recommendations for improving Canada's system of international taxation in various areas. These recommendations were developed with reference to the principles discussed above and support the Panel's broader conclusions on the tax policy direction that the government should take to improve the competitiveness, efficiency and fairness of the system. As noted in paragraph 1.12, the Panel believes the current international tax system is a good one and requires only some improvements. The recommendations in this report reflect this view.

Two key directives emerge from applying the Panel's principles:

- *The federal government should maintain the existing system for the taxation of foreign-source income of Canadian companies and extend the existing exemption system to all active business income earned outside of Canada by foreign affiliates.*
- *The federal government should maintain the existing system for the taxation of inbound investment and adopt targeted measures to ensure that Canadian-source income is properly measured and taxed.*

1.32 The principles and the recommendations in this report aim to improve Canada's international tax system by delivering predictable and more certain results while protecting the Canadian tax base.[25]

25 The Panel's recommendations are listed in Appendix A in the order in which they are discussed in the body of this report.

4. Taxation of Outbound Direct Investment

Introduction

4.1 Outbound direct investment can result in significant economic benefits for Canadians, including efficiency gains and greater productivity as described in Chapter 2. These benefits underlie the principle set out in Chapter 3 that Canada's outbound taxation rules should be competitive when compared with those of Canada's major trading partners. This principle is central to the discussion and recommendations in this chapter.

4.2 The basis of Canada's current outbound taxation system was a part of the 1972 tax reform package and has been in place since 1976. Although changes have been made over the years, the rules' basic features remain the same. The Panel believes this system has served Canada well in many respects.

4.3 In this chapter, the Panel discusses our analysis and conclusions regarding how the competitiveness of Canada's system of outbound taxation could be improved by broadening the current exemption system. The Panel also identifies other changes needed to update the system and maintain the integrity of Canada's tax base once a broader exemption system is adopted. Specifically, the Panel addresses the taxation of foreign-source income in the following areas:

- active business income, particularly when earned indirectly through foreign affiliates,
- capital gains arising on dispositions of shares of foreign affiliates,
- foreign passive income and its treatment under Canada's anti-deferral regimes, and
- expenses incurred to earn foreign-source income, particularly interest expense.

Alternatives for taxing foreign-source income

4.4 Broadly speaking, countries have three principal choices in how they tax foreign income earned through foreign entities:

- Accrual or Worldwide Basis of Taxation
- Deferral with Credit
- Full Exemption Method.

Accrual or Worldwide Basis of Taxation

4.5 Under the accrual or worldwide basis of taxation in its purest form, all domestic and foreign-source income earned directly or indirectly by a taxpayer is taxable in the taxpayer's country of residence on an accrual basis (that is, as it is earned) regardless of whether the foreign income is active or passive or whether the income is repatriated to the home country. A tax credit is provided by the resident country for any underlying foreign tax paid in respect of such income.

Deferral with Credit (the "Credit Method")

4.6 Under the Credit Method, the taxation of foreign active business income earned indirectly through foreign corporations is deferred until such income is repatriated to domestic shareholders. A tax credit is allowed for any underlying foreign income and withholding tax payments related to the income. This method is currently employed by the United States, the United Kingdom and Japan, among others.

Full Exemption Method (also known as the "Territorial Method")

4.7 Under a full exemption system, all foreign income, including capital gains on the sale of assets and shares of foreign companies, is exempt from domestic taxation when earned and when paid as a dividend to domestic corporate shareholders. Such income is subject to tax only in the jurisdiction in which it is earned, although domestic tax may arise when the income is later distributed by the domestic corporation to an individual shareholder. Most countries employ a full exemption system only for foreign active business income; passive income earned indirectly through certain foreign corporations is taxed on an accrual basis. In short, under a full exemption system, foreign-source income is either taxed domestically as it is earned (because it is passive income) or not at all.

Canada's current system

4.8 The current Canadian system for taxing foreign-source income has attributes of each of the above methods.

4.9 Income earned directly by a Canadian taxpayer from a branch in a foreign jurisdiction is taxed on a current basis, with a foreign tax credit available for any foreign tax paid on the income.

4.10 Income earned *indirectly* by a Canadian taxpayer through a foreign affiliate is taxed under a special set of rules known as the foreign affiliate regime. These rules apply where the Canadian taxpayer, either alone or together with related persons, holds at least a 10 percent direct or indirect interest in any class of shares of a foreign corporation (a "foreign affiliate"). The paragraphs that follow discuss the key features of the current foreign affiliate system.

Foreign active business income

4.11 Under the current foreign affiliate system, active business income earned by a foreign affiliate of a Canadian corporation is not taxable in Canada until such income is repatriated as a dividend to the corporation (except as noted in paragraphs 4.13 and 4.15).

4.12 A dividend from active business income earned by a foreign affiliate is exempt from Canadian tax if the affiliate is resident and carries on its business in a country with which Canada has a tax treaty (a "Treaty Country"). Under recently enacted changes for taxation years beginning after 2008, the same treatment applies to dividends from active business income earned by a foreign affiliate in a country with which Canada has a comprehensive Tax Information Exchange Agreement or TIEA (a "TIEA Country"). If an affiliate is not resident or does not carry on its business in a Treaty or TIEA Country, the Credit Method applies to the income.

4.13 Also under these new rules, if Canada does not conclude a TIEA with a country within five years after the beginning of negotiations to do so, the active business income earned by a foreign affiliate in that country will be treated as foreign accrual property income (see below).

Foreign accrual property income

4.14 Under Canada's foreign accrual property income (FAPI) rules, a Canadian resident shareholder is taxable on an accrual basis on amounts related to certain types of income earned by "controlled foreign affiliates",[26] with relief provided for any foreign tax paid on the income. FAPI includes passive income, such as interest, dividends (except dividends from other foreign affiliates), royalties and 50 percent of capital gains realized from the sale of property that is not "excluded property". A foreign affiliate's excluded property includes its property used to earn active business income and shares of another foreign affiliate where all or substantially all of the fair market value of the property of that other foreign affiliate is attributable to excluded property.

4.15 Additionally, under the "base erosion rules", income from certain business activities is treated as FAPI. Other rules treat income that would otherwise be active business income as FAPI where the business generating the income is not conducted principally with arm's-length persons or does not employ more than five full-time employees. Special exceptions to the FAPI rules apply to certain payments between certain foreign affiliates.

4.16 FAPI earned by a non-controlled foreign affiliate is subject to Canadian tax under the Credit Method.

26 A controlled foreign affiliate is a foreign affiliate that is controlled by a Canadian resident or a small group of Canadian residents. In determining whether a foreign corporation is a controlled foreign affiliate, there are additional rules that include shares owned by related or non-arm's-length persons.

Capital gains on sales of foreign affiliate shares

4.17 Fifty percent of capital gains realized by Canadian residents on the disposition of shares of a foreign affiliate is subject to Canadian income tax.[27]

4.18 Fifty percent of capital gains realized by a foreign affiliate on the sale of shares of another affiliate is considered to be FAPI unless the shares are excluded property. If such gains are from the disposition of excluded property, 50 percent of the gain is subject to Canadian tax when the proceeds are repatriated to Canada. Capital gains on the disposition of assets used in an active business in a Treaty or TIEA Country are fully exempt.

Assessing Canada's treatment of foreign active business income

4.19 In our consultation paper, the Panel suggested that our review should focus on whether Canada should move to a broader or full exemption system for taxing foreign active business income earned directly or indirectly by Canadian corporations. Our consultations and benchmarking research confirmed that this focus is appropriate.

4.20 The Panel revisited the alternative methods for taxing foreign active business income and concluded that an exemption system is the right choice for Canada. Our analysis of the other alternatives is set out in Appendix C. An exemption system is more consistent with the goal of encouraging the competitiveness of Canadian businesses operating globally and is also in step with the provisions many countries have in place or propose to adopt.[28]

4.21 The Panel believes that the exemption of foreign active business income earned by a foreign affiliate should be viewed as the norm for Canadian tax purposes.[29] Ours is a territorial view which asserts that such income should not be considered part of Canada's tax base. This view is consistent with current international norms — and the reality that little Canadian tax is collected on foreign active business income. The balance of this section reviews the aspects of Canada's system that led the Panel to conclude that Canada should broaden its current exemption system.

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27 For Canadian corporations, the gain can be reduced by any undistributed earnings of the disposed affiliate.

28 The tax regimes of Australia, France, Germany, Italy, the Netherlands and Sweden each provide for some level of exemption, in certain circumstances, for dividends from foreign corporations. Currently, 21 of 30 OECD countries use an exemption system. The United Kingdom, Japan and New Zealand have proposed or are considering moving to exemption regimes.

29 On this view, the exemption of dividends from foreign active business income would not be considered a tax preference or "tax expenditure". The Department of Finance report, *Tax Expenditures: Notes to the Estimates/Projections — 2004* (Ottawa: Public Works and Government Services Canada, 2004, at p. 7) describes tax expenditures as special tax rates, exemptions, deductions, rebates, deferrals and credits that have an impact on government revenue (that is, they have a cost) and reflect the government's policy choices. The report states that in order to define tax expenditures, it is necessary to establish a "benchmark" tax structure that applies the relevant tax rates to a broadly defined tax base — for example, personal income, business income or consumption. Tax expenditures are then defined as deviations from this norm.

Tracking surplus balances of foreign affiliates

4.22 In our review, the Panel heard that one of the predominant issues regarding Canada's current exemption system is the complexity associated with tracking surplus balances.

4.23 Canada's system for taxing foreign active business income earned through foreign affiliates has elements of both the Credit Method and Full Exemption Method. Some foreign profits ("surplus") are exempt on repatriation ("exempt surplus"), while others are eligible for relief for the foreign tax paid on the income from which the dividend was paid ("taxable surplus"). As a result, businesses must track all foreign earnings and account for them according to their treatment on repatriation to ensure they are appropriately taxed.

4.24 A business can compute its earnings for surplus purposes, for the most part, using the tax rules of the country where the foreign affiliate is resident and the country where the profits are generated. However, businesses must navigate through the many exceptions and special provisions within these rules. For example, some of these rules apply to specific transactions like capital gains. Depending on the transaction's character, the gain or loss needs to be accounted for separately and allocated to the appropriate surplus account. In certain circumstances, a business may be required to compute certain gains or profits under both foreign and Canadian tax rules, and using Canadian or a foreign currency, adding more complexity.

4.25 Businesses told the Panel that maintaining up-to-date exempt and taxable surplus balances is complicated, time-consuming and often overwhelming for a number of reasons:

- Preparing and filing foreign tax returns, which is the starting point for computing surplus balances, takes time. In some cases, foreign tax returns are not filed until many months after the end of the affiliate's taxation year.
- Surplus balances must be updated for changes arising from audits by foreign tax authorities. Sometimes, these changes are not made until after the affiliate has paid dividends based on previously calculated surplus balances, which can lead to adverse tax results. Information received after-the-fact or changes to foreign tax laws can also cause surplus balance adjustments.
- Businesses may have difficulty obtaining the information they need to determine the tax basis of their assets under the Canadian tax rules (for example, to calculate capital gains).
- The surplus of a foreign affiliate must be recomputed when there is a change in the ownership of the foreign affiliate, and the surplus implications of each reorganization involving a foreign affiliate must be re-analyzed if its earnings are adjusted or a previous year's surplus amounts revised.
- Accounting for different foreign currencies can compound the complexity and produce unintended results.

4.26 The surplus tracking requirements create a significant compliance burden for Canadian businesses (especially small and medium-sized businesses) and generate little, if any, Canadian tax revenue (see paragraph 4.30). Canada's rules governing outbound

investment through foreign affiliates would be greatly simplified if taxpayers did not have to maintain such accounts.

4.27 Eliminating surplus tracking would relieve the CRA of the significant administrative burden of reviewing taxpayers' surplus calculations when dividends are paid to Canadian corporate shareholders. Instead, the CRA could focus more of its limited resources on whether taxpayers are properly computing FAPI of an affiliate and applying transfer pricing rules in a way that does not understate domestic active business income (which is taxable) or overstate foreign active business income (which is exempt).

Dividends paid by foreign affiliates

4.28 The purpose of tracking the two surplus pools is to identify which dividends are exempt and which dividends are subject to Canadian tax.[30]

4.29 For many years, the Canadian tax system has granted an exemption for foreign active business income earned in countries with which Canada has a tax treaty. For the past 20 years, the portion of stock of Canada's direct investment abroad in treaty countries has ranged between 87 percent and 94 percent.[31] Based on the table below, of the total amount of exempt and taxable surplus dividends paid by foreign affiliates of Canadian companies between 2000 and 2005, about 92 percent were exempt.

> "In the absence of empirical evidence to the contrary, it is reasonable to assume that taxable dividends are repatriated only when they carry enough credits to eliminate any Canadian tax payable or when the Canadian corporation is not in a tax-paying position in the first place. Therefore, in effect, dividends from foreign affiliates are not taxed at the corporate level."
>
> — *Submission of Jinyan Li, at p. 4*

Table 4.1

Dividends Received by Canadian Taxpayers from their Foreign Affiliates, by Surplus Account, 2000–2005 (millions of dollars)

	2000	2001	2002	2003	2004	2005
Exempt	5,531	8,320	8,990	11,731	9,676	10,609
Taxable*	177	1,016	527	765	688	1,288
Other**	1,770	3,786	1,289	1,918	1,924	2,167
Total	**7,478**	**13,122**	**10,805**	**14,414**	**12,289**	**14,064**

* *Canadian taxes paid on taxable dividends received from foreign affiliates, including those categorized as "Other", depend on the taxpaying position of the recipients and the extent to which they are eligible to claim relief for taxes paid on the underlying active business income.*

** *Includes dividends received by companies which indicated that the dividends were paid from more than one type of account (that is, exempt surplus, taxable surplus and pre-acquisition surplus), or which did not indicate the type of surplus account from which the dividends were paid.*

Source: Canada Revenue Agency, T1134 Information Return.

30 Surplus balances are also relevant under current domestic rules for tracking "safe income" of Canadian companies. See Appendix B.

31 This range was established by the Panel using Statistics Canada data (CANSIM Tables 376-0051 and 376-0064). Statistics Canada country breakdown of Canadian direct investment abroad reflects the countries where funds are first invested and does not take into account funds subsequently redirected to another country.

4.30 The Panel was unable to determine how much Canadian tax was collected on the eight percent that were taxable surplus dividends. During the Panel's consultations, businesses and tax practitioners were united in the view that the amount collected is low.

4.31 The conclusion the Panel drew was that Canada's system already largely exempts foreign active business income earned by foreign affiliates.

4.32 In addition to the benefits that will arise from a simpler system, moving to a broader exemption system could also facilitate repatriation of foreign profits to Canada. These profits could then be redeployed more efficiently by Canadian businesses. While little tax is collected under the current system (and most earnings can be repatriated tax-free), some foreign affiliate earnings are not repatriated probably because of the inherent tax cost of doing so. These earnings may be redeployed outside Canada but perhaps not in the most advantageous way. Moving to a broader exemption system would eliminate such inefficiencies, with no significant fiscal consequences.

Conclusion

4.33 The Panel has concluded that Canada should formally adopt a broader exemption system for foreign active business income earned through foreign affiliates for the following reasons:

- A broader exemption system would be simpler, reducing the compliance burden for Canadian businesses and the administrative burden for the CRA.
- Broadening the exemption system would be revenue-neutral for the government, as dividends from foreign affiliates are rarely taxed under the current regime.
- A broader exemption system could facilitate repatriation of foreign profits, generating economic benefits for Canadian businesses and their owners.
- Our benchmarking research shows that taxing active business income at its source is consistent with the tax policies (or policy direction) of most other industrialized nations.
- As noted in paragraphs 3.13 to 3.14, concerns that formally adopting a broader exemption system would cause a migration of jobs or investment from Canada are not well supported.

RECOMMENDATION 4.1: *Broaden the existing exemption system to cover all foreign active business income earned by foreign affiliates.*

4.34 One implication of this recommendation is that all dividends from foreign affiliates would be exempt. However, as described starting at paragraph 4.79, certain passive income of foreign affiliates would continue to be taxed currently under Canada's anti-deferral regimes.

Tax Information Exchange Agreements and Canada's exemption system

4.35 As noted in paragraph 4.12, Canada's current exemption system for foreign active business income earned by a foreign affiliate extends to such income earned by a foreign affiliate in a TIEA Country for taxation years beginning after 2008. However, if Canada does not enter into a TIEA with a country within five years following the initiation of negotiations to do so, the active business income earned by a foreign affiliate in that country will be treated as FAPI.

4.36 TIEAs originate from the OECD's work on Harmful Tax Competition, which identified the lack of effective exchange of information as a key criterion in determining harmful tax practices. The 2002 OECD *Model Agreement on Exchange of Information on Tax Matters* set the standard.[32] TIEAs establish the terms under which contracting states help each other administer and enforce their domestic tax laws through the exchange of relevant information.

4.37 The terms of a TIEA and how it is used are defined by the contracting states. A TIEA usually contains provisions that:

- identify which taxes imposed in each country are subject to the agreement,
- describe how exchanges of information will occur,
- prescribe when a request for information may be declined, and
- treat any information received under the TIEA as confidential.

4.38 For countries with which Canada has no tax treaty, TIEAs are important to ensure that Canada can obtain sufficient information to enforce its tax laws and combat tax evasion.

4.39 A consequence of the Panel's Recommendation 4.1 is that the exemption system for foreign active business income earned by foreign affiliates should no longer be linked to tax treaties or TIEAs. The Panel believes there are sound reasons to detach the exemption system from tax treaties and TIEAs.

4.40 Over the years, some commentators have maintained that Canada's exemption system was conceived as a proxy for the Credit Method. Where a country's tax system was comparable to Canada's, the Credit Method would generate no further Canadian tax revenue in Canada and so it was simpler to exempt dividends from Canadian tax. On this view, tax treaties were considered a reasonable way to evaluate whether the tax regimes of other countries were comparable to Canada's.

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32 Organisation for Economic Co-operation and Development, *Model Agreement on Exchange of Information on Tax Matters* (Paris: OECD, April 2002).

4.41 However, although under pre-2008 rules a foreign affiliate's income had to be earned in a Treaty Country for dividends paid to a Canadian corporation to be entitled to exemption, the income was not required to bear tax at a level similar to the rate that would apply in Canada. Over the years, Canada has entered into tax treaties with low-tax countries and with countries that do not have comparable tax systems. Canada will probably continue to pursue tax treaties and TIEAs with such countries in the future. These developments counter the view that the current exemption system is a proxy for the Credit Method.

4.42 Additionally, Canada has always sought something in return for granting exemption for foreign active business income. In earlier years, granting exemption was meant to induce the other country to enter into a comprehensive tax convention with Canada. Now that Canada has 86 treaties, this incentive no longer seems necessary. With the TIEA initiative, the government seeks access to information and is prepared to grant an exemption for active business income in exchange for it.

4.43 Obtaining TIEAs is important for the Canadian tax system. However, the Panel believes that, like tax treaties, TIEAs should not be linked to Canada's exemption system. To preclude businesses from benefiting from the simplicity and other gains of a broader exemption system because a non-Treaty Country chooses not to negotiate a TIEA with Canada seems inappropriate.

4.44 The Panel also heard concerns about the current rule that treats active business income as FAPI if Canada does not enter into a TIEA with a country within five years of starting negotiations. The Panel was told that this rule puts an unfair onus on businesses to influence the local government to secure a TIEA. The Panel shares these concerns.

RECOMMENDATION 4.2: *Pursue tax information exchange agreements (TIEA) on a government-to-government basis without resort to accrual taxation for foreign active business income if a TIEA is not obtained.*

4.45 The Panel believes the government should monitor international developments and participate in discussions regarding jurisdictions that may be viewed as uncooperative in the sharing of information that is needed for countries like Canada to enforce their tax laws.

Capital gains arising on dispositions of foreign affiliate shares

4.46 As noted at paragraph 4.17, 50 percent of capital gains realized by Canadian residents on the disposition of shares of a foreign affiliate is subject to Canadian income tax. A capital gain realized by a foreign affiliate on the sale of shares of another foreign affiliate is subject to Canadian tax on a current basis unless the shares are excluded property. Whether the foreign affiliate shares are excluded property or not, 50 percent of the gain is included in the disposing affiliate's exempt surplus and the other 50 percent in taxable surplus.

4.47 Conversely, 50 percent of capital losses realized by Canadian residents on the disposition of shares of a foreign affiliate may be available in certain circumstances to shelter income from Canadian tax. A capital loss realized by a foreign affiliate on the sale of shares of another foreign affiliate may reduce its exempt and taxable surplus.[33]

4.48 In a system that exempts foreign active business income earned by foreign affiliates, consideration should be given to the appropriate tax treatment of capital gains and losses realized by a Canadian shareholder or a foreign affiliate on a disposition of the shares of another foreign affiliate where the shares derive all or substantially all of their value from assets used principally to earn active business income (referred to in this section and in Appendix B as "active business assets").

4.49 One view is that capital gains are passive in nature and similar to investment income, and so they should remain taxable. Another view is that exempting capital gains arising on the sale of shares of a foreign affiliate is appropriate if the income generated by the affiliate is also exempt from Canadian tax; that is, if the capital appreciation inherent in the share value represents the present value of the affiliate's future active business earnings stream. This view also accords with the treatment that would occur if the foreign affiliate's active business assets were sold, rather than its shares, and the proceeds were paid as a dividend to Canada. In a system that exempts capital gains, capital losses from dispositions of the same types of property should be denied.

4.50 The Panel's benchmarking research confirms that most countries that exempt dividends received from a foreign affiliate from domestic taxation also exempt capital gains realized on a disposition of the shares of the foreign affiliate. The tax regimes of Australia, France, Germany, Italy, the Netherlands and Sweden each provide for some level of exemption, in certain circumstances, for dividends from foreign corporations and capital gains on foreign corporation shares. New Zealand and the United Kingdom have proposed or are considering similar regimes.

4.51 Practically, in moving to a system that exempts capital gains on dispositions of foreign affiliate shares, little tax revenue should be at risk for the following reasons:

- Foreign affiliates are often held through foreign holding companies so that such dispositions are not immediately subject to tax in Canada.
- For the reasons noted earlier in this chapter, where a foreign affiliate realizes a capital gain from the disposition of another foreign affiliate's shares, the portion of the gain that would otherwise become taxable surplus is rarely repatriated to Canada. If it is, Canadian tax is rarely payable on those distributions.

33 Special provisions in the Act may apply to reduce or deny the loss otherwise determined.

Conclusion

4.52 The Panel believes that Canada's exemption system should be extended to capital gains realized by Canadian shareholders on dispositions of foreign affiliate shares (and capital gains realized by foreign affiliates on the sale of shares of other foreign affiliates) where the shares derive all or substantially all of their value from assets used or held principally to earn active business income. The Panel reached this conclusion for the following reasons.

- Exempting capital gains arising on the sale of shares of a foreign affiliate is appropriate because the affiliate's income would also be exempt from Canadian tax. This treatment is consistent with the view that foreign active business income should be exempt from Canadian income tax.
- The Panel's benchmarking research confirms that most countries that exempt dividends received from a foreign affiliate from domestic taxation also exempt the capital gain realized on a disposition of the shares of the foreign affiliate.
- Little tax revenue should be at risk if capital gains realized on dispositions of foreign affiliate shares were exempt.

4.53 At first glance, exempting gains on the sale of foreign affiliate shares while taxing gains on the sale of Canadian company shares may seem inconsistent. This difference can be accepted on the basis that the current rules are out of step with most other countries that have exemption systems[34] and that this approach could eliminate another aspect of surplus tracking, resulting in a much simpler system for businesses and the CRA.

RECOMMENDATION 4.3: ***Extend the exemption system to capital gains and losses realized on the disposition of shares of a foreign affiliate where the shares derive all or substantially all of their value from active business assets.***

Related issues

4.54 The Panel has identified certain technical and policy issues that the government should address in moving to a broader exemption system that exempts capital gains arising on sales of foreign affiliate shares.

Excluded property

4.55 As currently defined, "excluded property" is limited to property of a foreign affiliate (not of a Canadian taxpayer), which is used or held principally for the purpose of earning active business income. It also includes shares of another foreign affiliate where all or substantially all of the fair market value of the property of the other foreign affiliate is attributable to excluded property. Property that is not excluded property is referred to in this report as "non-excluded property".

34 Australia has in place a similar system that taxes gains on sales of domestic company shares while exempting gains on sales of foreign affiliate shares.

4.56 To implement Recommendation 4.3, the "excluded property" definition could be extended to include shares of a foreign affiliate held by a Canadian corporation (i.e., not only shares of a foreign affiliate held by another foreign affiliate) so that the exemption for capital gains from the disposition of foreign affiliate shares could then be referenced to shares that are excluded property.

Non-excluded property

4.57 The Panel does not believe that full exemption from capital gains taxation under a broader exemption system should extend to shares of foreign affiliates that do not derive all or substantially all of their value from active business assets. Such gains should remain taxable; otherwise, Canada's tax base would be exposed to the possible loss of passive income that should be subject to Canadian tax.

4.58 The government should consider what results are appropriate where the all-or-substantially-all test is not met. For example, Australia has adopted an approach of taxing only the pro-rata share of the gain that relates to non-excluded property. Canada could adopt a similar approach which would exempt the portion of the gain that relates to active business assets on the basis that the same result would occur had active business assets been sold by the foreign affiliate and the proceeds distributed as an exempt dividend.

4.59 See Appendix B for discussion of several additional issues related to a capital gains exemption for certain foreign affiliate shares.

Definition of "foreign affiliate"

Canada's approach

4.60 The benefit of foreign affiliate treatment under the current Canadian system is the availability of an exemption or relief for the underlying foreign tax paid by the foreign affiliate in respect of dividends received by the Canadian shareholder. The disadvantage of such treatment is that where a foreign affiliate becomes a controlled foreign affiliate, its FAPI is taxed in Canada on an accrual basis.

4.61 A foreign corporation is a foreign affiliate under Canada's rules if:

- the Canadian investor has a direct or indirect interest of at least one percent in any class of shares of the foreign corporation, and
- the aggregate of the Canadian investor's interest and the highest direct or indirect interests held by persons related to the investor in any class of shares of the foreign corporation is at least 10 percent.

Other countries' approaches

4.62 None of the countries studied in the Panel's review employ a test based on the fair market value of the shares owned to determine foreign affiliate status. Other countries, including the United States, the United Kingdom and Australia, use a test based on votes attributed to the shares owned. Some countries seem to substitute value in such tests with a concept similar to Canada's concept of "paid-up capital" (i.e., the amount of a corporation's share capital that has been fully paid by shareholders). Presumably, this approach would produce a more consistent result than an approach based on fair market value.

4.63 Some countries, such as Sweden and the Netherlands, employ a flexible test whereby an investment that meets one of several conditions is considered a non-portfolio investment and is thus eligible for the dividend exemption. For example, such a test could use a threshold of 10 percent of votes or share capital.

4.64 Of the countries studied that have a form of exemption system, the percentage thresholds vary from five to 15 percent, with many of these countries settling on 10 percent.

4.65 Canada's current foreign affiliate rules employ a 10-percent-votes-and-value test to establish which affiliates can make certain types of payments to other affiliates that will be treated as active business income of the other affiliates and added to their exempt surplus.[35]

Conclusion

4.66 Given the Panel's recommendation to broaden the exemption system to cover all dividends from foreign active business income and capital gains on dispositions of shares of foreign affiliates that are excluded property, the current ownership threshold may require review, especially in light of the thresholds in place in other countries.

4.67 Canada's FAPI regime taxes passive income of a "controlled foreign affiliate" on an accrual basis. However, a foreign company cannot meet the "controlled foreign affiliate" definition unless it is first a foreign affiliate. Tightening the requirements to achieve foreign affiliate status could open opportunities for arrangements that inappropriately avoid the FAPI regime because the foreign corporation does not meet the definition of "foreign affiliate".

35 When a Canadian shareholder has a direct or indirect interest in an affiliate that represents at least 10 percent of its voting shares and the fair value of its assets, the shareholder is said to have a "qualifying interest" in that affiliate. The role of these inter-affiliate payments within the exemption system and the FAPI regime is discussed below in paragraphs 4.126 to 4.129.

4.68 However, the Act currently sets out both specific and general anti-avoidance rules to prevent tax avoidance schemes where foreign affiliate status is considered to have been achieved inappropriately. Since these provisions also apply where foreign affiliate and controlled foreign affiliate status are inappropriately avoided, they should act to deter such tax avoidance schemes.

4.69 The Panel notes that the Technical Committee on Business Taxation recommended strengthening the "foreign affiliate" definition so that "only foreign companies in which Canadian corporations have a significant equity interest can be considered as foreign affiliates."[36] No legislative proposals were tabled to adopt this recommendation.

4.70 Raising the threshold for an investment to be considered a direct investment and thus an investment in a foreign affiliate could adversely affect the treatment of existing investments of Canadians in foreign corporations that currently qualify as foreign affiliates. The government should undertake thorough consultation and consider appropriate transitional rules before taking any action in this area.

4.71 If the government were to tighten the rules in this area, the Panel believes it would be most appropriate to take a flexible approach that would allow an investment to meet one of several tests (for example, 10 percent of either votes, share capital or value).

RECOMMENDATION 4.4: *Review the "foreign affiliate" definition, taking into account the Panel's other recommendations on outbound taxation, the approaches of other countries, and the impact of any changes on existing investments.*

Related Issues

Application to other foreign entities

4.72 Under the current rules, only a foreign corporation can qualify as a foreign affiliate. This treatment presumes that active business is carried on only through entities that are corporations. In many countries, business can be conducted through entities or forms of association that are not corporations but are taxed as if they were. In some countries, using a corporation may not be the optimal or most tax-efficient form of association through which to conduct certain businesses locally. However, using the better form of association may have adverse Canadian tax consequences.

4.73 The Panel suggests the government consider amending the definition of "foreign affiliate" of a taxpayer resident in Canada to include any non-resident entity where the taxpayer and related persons hold equity interests in the entity that would be the equivalent of an interest in a foreign affiliate if the entity were a corporation and its equity interests were shares.

36 *Report of the Technical Committee on Business Taxation*, at p. 6.10.

Income from foreign branches

4.74 Conceptually, there is no reason to tax foreign-source active business income earned through a foreign branch of a Canadian company differently than such income earned through a foreign affiliate. However, exempting a foreign branch's active business income from Canadian tax would require complicated rules. For example, new rules would be required to tax the FAPI of the branch on an accrual basis.

4.75 In our consultations, the Panel did not discern any strong support for extending the exemption to foreign branch income, although it was widely agreed that such a move makes sense in theory.

4.76 The Panel believes that treating the foreign active business income of foreign branches and foreign affiliates more consistently is a desirable goal, but the practical difficulties involved currently outweigh the benefit of uniform treatment.

4.77 For these reasons, the Panel suggests no fundamental changes to the taxation of foreign branch income at this time.

4.78 Should the government decide to extend the exemption system to branches, the Panel also suggests that it work closely with the industries that would be most affected. The Panel suggests that, if such a system were adopted, the government consider allowing businesses to make a one-time, irrevocable election to opt into the new regime.

Foreign accrual property income and Canada's anti-deferral regimes

4.79 This section of the report addresses passive income earned indirectly through foreign corporations and other foreign entities.

Background — Canada's current anti-deferral regimes

4.80 Certain Canadian tax rules aim to ensure that the Canadian tax base is not eroded by Canadian resident taxpayers transferring passive investments and certain business activities to foreign entities to avoid or defer the Canadian tax otherwise payable had the income been earned directly in Canada. These rules, which reflect the third principle described in paragraph 3.3, are known as "anti-deferral regimes".

4.81 Because passive income is highly mobile, without such rules, Canadian businesses could easily convert domestic passive income into foreign income that is unrelated to its foreign business operations, and thereby escape domestic tax.

4.82 Canada now has three anti-deferral regimes that may apply to a taxpayer in respect of a foreign entity. These are:

- the FAPI regime,
- the foreign investment entity (FIE) regime, and
- the non-resident trust (NRT) regime.[37]

4.83 The Panel heard that, despite some problems, the FAPI regime is well understood and accepted. However, as discussed below, serious concerns were expressed about the proposed FIE and NRT rules.

FAPI regime

4.84 To deter arrangements in which controlled foreign affiliates of taxpayers resident in Canada earn and accumulate passive income (and certain other business income) outside of Canada, the FAPI regime taxes such income on an accrual basis. This treatment allows foreign passive income to be taxed currently and foreign active business income to be tax-deferred in accordance with the tax policy underlying the current foreign affiliate regime.

4.85 Passive income earned by a foreign affiliate that is not a controlled foreign affiliate is not taxed on an accrual basis in Canada. Such income is still FAPI but it is currently subject to Canadian tax under the Credit Method on repatriation. This treatment reflects the view that if the Canadian shareholder does not control the foreign affiliate, there is less opportunity for tax avoidance and the Canadian shareholder should not be subject to tax on the income until it is received as a dividend.

FIE regime

4.86 Where a taxpayer has interests in non-resident entities that are not considered to be interests in foreign affiliates subject to the FAPI regime, the FIE regime is intended to produce a result similar to the FAPI regime. Since the FAPI regime taxes passive income earned by a controlled foreign affiliate on an accrual basis, the FIE regime should not apply to such interests.[38]

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37 Proposed new rules on foreign investment entities and non-resident trusts were announced in the February 1999 budget. The effective date of the proposed new rule was postponed as the legislative process unfolded. Draft legislation was released in August 2001, and a detailed Notice of Ways and Means was tabled in October 2003. Revised draft legislation was released in July 2005. In November 2006, the proposed new rules were given first reading in the House of Commons as Bill C-33 (which lapsed when Parliament was prorogued in September 2007). The proposed new rules were reintroduced in October 2007 in Bill C-10 and quickly moved from the House of Commons to the Senate for approval. However, Bill C-10 lapsed when a general election was called for October 14, 2008. In this report, any reference to the existing rules means those that are enacted, and any reference to the proposed new rules means the proposals as they read in Bill C-10.

38 One exception is for indirect interests in property defined as "tracked property." The FIE regime's tracked property rules can apply to shares of a controlled foreign affiliate if their value tracks certain investment properties of the affiliate.

4.87 The FIE regime applies to an interest of a taxpayer in a non-resident entity that is considered to be a FIE; any non-resident entity is a FIE unless it can be shown that either the entity's principal undertaking is not conducting an investment business or that more that 50 percent of the carrying value of its property is not investment property. Once a non-resident entity is determined to be a FIE, the rules apply to the taxpayer in respect of its participating interests in the FIE.

4.88 The FIE regime is an all-or-nothing one: if the foreign entity is a FIE, there is no means to defer the taxation of active business income of the entity. Instead, all of the income of the entity or a proxy for its income attributable to the taxpayer's interests in the entity is taxed on an accrual basis in Canada.

NRT regime

4.89 The NRT regime does not operate in the same way as the FAPI and FIE regimes; it does not attribute income of a non-resident entity to a taxpayer who has a beneficial interest in a non-resident trust. Rather, under certain conditions, the NRT regime treats a non-resident trust as being resident in Canada and treats the contributors and beneficiaries of the trust as being jointly liable, together with the trustee, for the Canadian tax of the trust.

4.90 A non-resident trust is deemed to be resident in Canada if there is a resident contributor or a resident beneficiary under the trust. This regime targets the use of non-resident trusts to earn income on behalf of Canadian residents. Certain family and other trusts are excluded from the rules.

Evaluating Canada's current anti-deferral regimes

4.91 The anti-deferral rules are integral to Canada's international tax rules and are needed to protect the Canadian tax base. While supporting the position that income from an active business earned by foreign affiliates should be exempt from Canadian tax, the Panel believes that passive income should be subject to Canadian tax to prevent its accumulation offshore where the taxpayer's intent is to avoid Canadian tax. Simply put, the Panel believes there is no good tax policy reason to favour foreign over domestic passive income. The Panel believes that most Canadians share this view, and we encountered no contrary opinion during our consultations.

4.92 However, in accordance with the principles set out in Chapter 3, the concern with tax avoidance must be weighed against any compliance and administrative costs that may impede the ability of Canadian companies to compete in global markets.

4.93 Under the broader exemption system for active business income proposed by the Panel, there could be a tendency to introduce or extend complex rules to protect the Canadian tax base that would increase the compliance and administrative burden for taxpayers and the CRA. The Panel heard that Canada's anti-deferral rules, especially the proposed FIE and NRT regimes, are already too complex. The Panel also heard that some aspects of the current anti-deferral rules overreach or overlap, diminishing the competitiveness of Canadian businesses.

> "(T)he FIE and NRT... rules ... are overbroad, complex, convoluted, difficult to apply, and virtually impossible for taxpayers to comply with."
>
> — *Submission of the Tax Executives Institute, at p. 13.*

4.94 The Panel believes that, to preserve the integrity of the Canadian tax base, some complexity in the anti-deferral regimes is inevitable. However, the Panel also believes that there is room to improve these rules.

Integrating the current anti-deferral regimes

4.95 Some complexity could be reduced by integrating the three anti-deferral regimes into one or two regimes.[39] Yet, while the Australian Government Board of Taxation recently acknowledged that Australia's equivalent of Canada's FAPI and FIE regimes could be better integrated, the Board recommended focusing reform efforts on desired outcomes and policy factors relevant to taxing passive foreign-source income on a current basis rather than on harmonizing the existing regimes.[40]

4.96 Some commentators believe that it may be better to integrate at least the current FAPI and proposed FIE regimes to reduce complexity and overlap. However, integrating the two regimes may be difficult in part because the FAPI regime takes a "transactional approach" for taxing passive income while the FIE regime takes the "entity approach".[41]

39 For a discussion of reform options, see Arthur J. Cockfield, *Examining Policy Options for the Taxation of Outbound Direct Investment*, research report prepared for the Advisory Panel on Canada's System of International Taxation (September 2008), at section 4.4.1.

40 Australian Government, The Board of Taxation, *Review of the Foreign Source Income Anti-Tax-Deferral Regimes* (January 2008), at p. 2.

41 Under a "transactional" approach, taxation rules apply based on the active or passive character of income derived from a particular transaction; under an "entity" approach, taxation rules apply based on the composition of the assets from which the entity principally derives its income and gains.

Controlled foreign affiliates

The Panel believes the FAPI regime's current transactional approach is best suited to taxing passive income earned by controlled foreign affiliates. Use of an entity approach could ease the compliance and administrative burden on taxpayers and the CRA in quantifying the income that should be taxed in Canada on an accrual basis. However, the Panel believes that where planning steps are taken to reduce the passive income relative to income from the entity's active business assets, such an approach might allow passive income of controlled foreign affiliates to escape Canadian tax. Further, if the passive income is substantial relative to the active income, the entity approach could cause certain active business income to be taxed currently as though it were passive income.

The Panel believes the compliance and administrative burden associated with the current FAPI regime is acceptable and necessary to protect the Canadian tax base, particularly given the Panel's recommendation to move to a broader exemption system for foreign active business income. Moreover, businesses will benefit from reduced complexity in other areas, for example, with respect to surplus balances of foreign affiliates that no longer need to be tracked.

Non-controlled foreign affiliates

Under the current rules, FAPI of a non-controlled foreign affiliate is taxed under the Credit Method. It would be inappropriate to exempt such income from tax in Canada. If the government extends the existing exemption system to dividends received from foreign affiliates and for capital gains realized on the disposition of shares of foreign affiliates, thereby possibly eliminating the need to track surplus accounts, a solution must be found for taxing passive income earned by non-controlled foreign affiliates.

One approach would be to tax this income under a FIE regime. However, the Panel heard criticism about the complexity of the proposed FIE regime and the burden it places on Canadian businesses of all sizes.[42] The Panel believes that the compliance burden for taxpayers and the administrative burden for CRA would increase significantly if the proposed FIE regime were to be relied upon to tax passive income of non-controlled foreign affiliates.

The Panel considered whether the existing FAPI regime should be extended to tax passive income of all foreign affiliates on an accrual basis while applying the FIE regime only where the non-resident entity is a FIE but not a foreign affiliate. This treatment would take a transactional approach to investments that qualify as foreign affiliates and an entity approach to portfolio investments. The bright-line distinction would eliminate overlap between the FAPI and FIE regimes by narrowing the scope of the FIE regime to entities that are not foreign affiliates.

42 Similar concerns were expressed about the NRT regime.

4.102 The Panel recognizes that this approach is not as straightforward as it might seem, though it may have some support.[43] With respect to controlled foreign affiliates, Canadian taxpayers typically control or influence their affiliate's investment in passive-type activities, including the timing of the repatriation of such income derived from such activities, and they are also in a position to access the information needed to compute the resulting FAPI that is subject to tax in Canada. However, Canadian investors in non-controlled foreign affiliates might not be able to obtain such information, or control or influence the level of investment in passive activities and the repatriation of the resulting income. If the FAPI regime were extended to all foreign affiliates, the manner in which the FAPI rules apply to non-controlled foreign affiliates may need to be modified.

Conclusion

4.103 The Panel believes that our recommendation to adopt a broader exemption system raises questions about the scope and interaction of Canada's existing anti-deferral regimes. In particular, the Panel believes that the proposed FIE and NRT rules should be reconsidered to ensure that their need and scope are consistent with the Panel's recommendations and the principles in Chapter 3 regarding the international taxation of outbound investments by Canadian businesses.

4.104 The Panel has concluded that the government should undertake a fresh review to coordinate the FAPI, FIE and NRT regimes. This review should aim to ensure all passive income is taxed on an accrual basis and to focus the scope of these rules so they do not impede bona fide commercial business transactions.

4.105 Also in line with the Panel's principles, any proposed change to the scope and interaction of the anti-deferral regimes should undergo full consultation.

RECOMMENDATION 4.5: *In light of the Panel's recommendations on outbound taxation, review and undertake consultation on how to reduce overlap and complexity in the anti-deferral regimes while ensuring all foreign passive income is taxed in Canada on a current basis.*

4.106 The Panel believes that this recommendation and those that follow in this section will reduce the complexity of these rules, ease the compliance and administrative burden on taxpayers and the CRA, and enhance the integrity of Canada's international tax system.

43 In its submission to the Panel, the Canadian Life and Health Insurance Association remarked at p. 13 that a measure that would reduce unnecessary complexity "would be to lower the threshold for 'controlled foreign affiliate' status to broaden the scope of the foreign accrual property income rules, which are time-tested and understood by taxpayers."

Scope of the FAPI rules

4.107 As noted, the Panel observed a broad consensus regarding the appropriateness of the FAPI regime.

4.108 Over the years, the government has taken steps to strengthen these rules to deter the avoidance of Canadian taxation with respect to passive income earned by foreign affiliates.[44]

4.109 A key issue is distinguishing between passive income, which should be taxed in Canada on an accrual basis, and foreign active business income, which the Panel proposes should be exempt from Canadian tax. The Panel heard concerns over the appropriateness and scope of certain aspects of the current rules for determining passive income that is taxed as FAPI.

Base erosion rules

4.110 The base erosion rules are intended to prevent the erosion of Canada's tax base resulting when taxpayers divert income from Canadian-source activities to foreign jurisdictions. Such activities include the earning of income from the sale of property, interest and leasing income, insurance income and income from providing certain services. Under certain circumstances, such income will be treated as FAPI.

4.111 Base erosion rules are a feature of many other countries' foreign affiliate regimes.[45] Historically, such rules were justified to protect the domestic tax base against situations where income is diverted to a foreign country where only nominal value-adding economic activities may be taking place.

Issues under the base erosion rules

4.112 The Panel heard that the scope of the current rules may be too broad and that the policy underlying these rules is outdated in certain situations.[46]

4.113 This criticism is not surprising. The appropriateness of base erosion rules is being debated in a number of countries, particularly as many of them have the stated policy objective of increasing the global competitiveness of their domestic corporations. For example, the United States recently reviewed the impact of its base erosion rules (among others) on the competitiveness of U.S. businesses; and earlier this year

44 See in particular the amendments to the foreign affiliate rules released on January 23, 1995 and further modified by minor changes contained in Bill C-70 (part II), tabled in the House of Commons on February 16, 1995. While these amendments did not make any fundamental changes to the foreign affiliate regime (as it was at the time), they did address a number of technical deficiencies and thus have significantly affected many taxpayers.

45 These rules or parts thereof are also referred to as "base company income" and can also include income from the sale of goods and services provided by one foreign affiliate to another.

46 See submissions from the Canadian Bankers Association, the Joint Committee on Taxation of The Canadian Bar Association and The Canadian Institute of Chartered Accountants, KPMG LLP, Deloitte & Touche LLP, Telus Corporation, and Thorsteinssons LLP.

proposed regulations were released that provide a relieving exception to those rules.[47] In March, the Australian Board of Taxation proposed to eliminate all of that country's base company income rules concluding that such rules "increasingly place firms in Australia at a competitive disadvantage in overseas markets."[48] New Zealand also acknowledged that it had heard that "some features of (its) proposed rules for taxing royalties and base company income would be burdensome and could inhibit active businesses."[49] In July, New Zealand introduced a tax bill that included provisions scaling back its base erosion rules.[50]

4.114 Critics argue that the base erosion rules are unnecessary, especially now that most countries have extensive transfer pricing rules in place to ensure that the profit allocated among the countries involved in a transaction is commensurate with the activity taking place within each country.[51] Canada introduced a new transfer pricing regime in 1998 after its current base erosion rules were enacted.

4.115 More importantly, the Panel heard that certain of Canada's base erosion rules prevent Canadian businesses from effectively managing their global supply chains. In current global business models used by many international businesses, few goods and services are typically produced entirely in one location. Businesses seek the best location to undertake each activity, whether design, engineering, manufacturing, marketing or after-sales service. International businesses now organize supply chains more efficiently, reducing costs and standardizing services and their delivery across business groups in many countries. Canadian and foreign businesses commonly have global framework agreements and centralized procurement arrangements for financial, technical, engineering, communications, information technology, marketing, management and other services.

4.116 Under global supply chain management, Canadian businesses can take advantage of cost savings associated with outsourcing and manufacturing abroad through foreign affiliates to enable them to compete more effectively globally.[52] Canadian businesses may acquire foreign enterprises to enhance this process, which invariably results in Canadian businesses acquiring goods and services from their foreign affiliates and sometimes gives rise to FAPI under the current rules.

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47 See Joint Committee on Taxation, *The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses* (JCX-22-06) (June 22, 2006). On February 27, 2008, proposed regulations were released that would modify the "manufacturing exception" to what constitutes foreign base company sales income for purposes of subpart F of the U.S. Internal Revenue Code.

48 Australian Government, The Board of Taxation, op. cit., at p. 37.

49 Speech by the Honourable Peter Dunne, Minister of Revenue, to the International Fiscal Association Conference 2008, Christchurch, New Zealand, March 14, 2008.

50 New Zealand, Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill, July 2008.

51 Others disagree, however: the submission to the Panel of the *Chaire de recherche en fiscalité et en finances publiques* of the Université de Sherbrooke cautions that base erosion rules should be maintained as a backstop to the transfer pricing rules (at p. 17).

52 Submission of the Conference Board of Canada to Canada's Advisory Panel on International Taxation, at p. 2.

4.117 The Panel heard the following examples of situations of income being inappropriately subject to tax arising under the current FAPI regime.

- A Canadian company acquires a foreign company with special expertise. The foreign company carries on an active business, principally with third parties, but also provides some services to the Canadian company. Under the current rules, income from these services would be taxed in Canada on an accrual basis as FAPI.
- A Canadian investment fund manager acquires operations outside of Canada. The Canadian investment fund manager engages its newly acquired offshore affiliates to provide investment advisory services to its Canadian mutual funds. Under the current rules, the service fees paid to the offshore affiliates would be FAPI.[53]
- A U.S. subsidiary of a Canadian parent can sell product it makes or sources in the United States to its Canadian parent without having the income on that sale considered FAPI. However, foreign businesses now commonly manufacture and source product in more than one jurisdiction. For example, assume the U.S. subsidiary assembles an aircraft using components made in the United Kingdom and Japan and sells the aircraft to its Canadian parent to on-sell to a client. In this case, the U.S. subsidiary's income from the sale would be FAPI to the Canadian parent. Moreover, foreign multinationals may employ the same structure to sell to their Canadian subsidiaries to reduce their global costs and increase production efficiency, thereby gaining a competitive advantage relative to Canadian companies in the Canadian marketplace.[54]

Investment business rules

4.118 Under the current rules, certain income from businesses carried on by foreign affiliates that might otherwise be considered to be active business income is instead treated as FAPI unless certain conditions are met. Such income includes income from businesses established principally to earn interest, dividends, rents or royalties or income from insurance or reinsurance, factoring and the disposition of certain properties.[55] For example, rental income derived by a foreign affiliate carrying on a large real estate business with hundreds of employees is considered active business income and not FAPI. However, interest income earned by an affiliate on bank deposits that represent amounts in excess of what is needed to run the affiliate's active business is considered passive income and taxed as FAPI.

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53 Submission of the International Funds Institute of Canada to Canada's Advisory Panel on International Taxation, at pp. 1-2. Conversely, when a Canadian investment fund manager provides services to a non-resident, there is a risk that the non-resident might be viewed as carrying on business in Canada. Recognizing this measure of uncertainty for non-residents vis-à-vis their Canadian investment activities, the government introduced section 115.2 which deems a non-resident not to be carrying on business in Canada so long as certain conditions are met. Technical issues related to these conditions are discussed in Appendix B.

54 Submission from Deloitte & Touche LLP to Canada's Advisory Panel on International Taxation, at p. 6.

55 Subject to the exception described in the next section.

4.119 The Panel heard that certain tests providing exceptions from the investment business rules can be difficult to meet, causing otherwise active business income to be treated as FAPI.[56] For example, many real estate development, leasing, management and other global businesses linked to real property tend to be carried on in multiple foreign entities. This is done in many circumstances for non-tax reasons such as financing and raising capital, insurance, limiting legal liability, and creditor-proofing. In most cases, if all the relevant entities in the corporate group were treated as one taxpayer, there would be no doubt that the taxpayer would be considered to be carrying on an active business. The use of multiple entities can make it difficult for these businesses to meet the conditions necessary to ensure their income is treated as active business income and not FAPI.

Conclusion

4.120 In the Panel's view, foreign active business income should not be taxable in Canada. The base erosion and the investment business rules are designed to restrict the exemption from Canadian tax to commercially-driven foreign active business income.

4.121 The Panel believes that Canada's base erosion rules and the "investment business" definition should not target income arising from activities that are carried out for bona fide business reasons, enhance the competitiveness of Canadian companies in the global marketplace and do not aim to erode the Canadian tax base. The Panel acknowledges that this distinction can be difficult to make. The base erosion rules and the investment business rules must be continually revisited to ensure they remain properly focused as international business practices evolve.

4.122 The Panel heard that the base erosion rules are unnecessary in light of Canada's transfer pricing rules. In the Panel's view, transfer pricing rules pose administrative challenges. Well-designed and properly focused base erosion rules complement the transfer pricing rules and provide certainty about the types of income that should be subject to Canadian tax, without adversely affecting the global competitiveness of Canadian businesses.

4.123 For this reason, the Panel believes that base erosion rules which target income derived from Canadian debt obligations, Canadian leasing activities, and the insurance of Canadian risks are appropriate and should be retained.

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56 In particular, the test requiring that more than five employees be employed full-time by the affiliate in the conduct of its active business was brought to the Panel's attention.

4.124 However, the Panel believes that the base erosion rules (and the rules regarding the sales of goods and services between foreign affiliates carrying on active businesses) are not appropriate to the extent they impede the efficient business operations of Canadian companies. While acknowledging that certain relieving provisions have been introduced in recent years to prevent certain of these types of income from being treated as FAPI, the Panel believes more can be done.

RECOMMENDATION 4.6: ***Review the scope of the base erosion and investment business rules to ensure they are properly targeted and do not impede bona fide business transactions and the competitiveness of Canadian businesses.***

4.125 The Panel also submits that if the FAPI regime is extended to non-controlled foreign affiliates, the government should consider the extent to which the base erosion and investment business rules would apply differently to non-controlled foreign affiliates.

Inter-affiliate payments

4.126 Special exceptions to the FAPI rules may apply in the case of interest, royalties and certain other payments received by one foreign affiliate from another where, as described earlier, the Canadian shareholder has a qualifying interest in the payor and payee affiliates. For example, interest income of a foreign affiliate received from another foreign affiliate is not considered FAPI if the second affiliate deducted the interest in computing its active business income (among other conditions). This exception is referred to as the "inter-affiliate payment exception" and is used by many Canadian companies to structure and finance their foreign operations efficiently and tax-effectively.

4.127 The United States has adopted a temporary rule similar to Canada's. U.S. corporations can also achieve the same effect using the "check-the-box" rules described in the box on page 51. Other countries, such as Australia (and New Zealand under current proposals), have similar rules but restrict their application to payments between affiliates within the same country.

4.128 The Panel strongly believes that Canada should retain its current rule that treats such payments between affiliates, which would otherwise be FAPI, as income from an active business. In the Panel's view, this rule preserves the underlying character of active business income that is the source of the inter-affiliate payment and minimizes the situations where these payments attract Canadian tax under the FAPI regime. Eliminating this rule would impair the competitiveness of Canadian companies relative to other foreign companies that benefit from the same or similar rule in their home country.

4.129 The Panel believes that a "same-country exception", like that in place in Australia, suffers from the same limitation as certain current base erosion rules — it does not acknowledge that companies operate globally and do not carry on all of their active operations within a single country or entity. Moreover, given that the Panel

recommends that Canada cede taxation of foreign active business income to the foreign-source country without condition, how Canadian multinationals structure their foreign operations within or between foreign jurisdictions to minimize foreign income tax on their active business earnings should be irrelevant from a Canadian tax perspective. Adhering to this principle provides the flexibility that businesses need and appropriately treats separate foreign entities within a corporate group as a single entity carrying on an active business.

Possible exemption for passive income earned in high-tax countries

4.130 The Panel considered whether it would be appropriate to exempt passive income from current taxation under the FAPI (and possibly the FIE) regime if the income of the entity was subject to a certain level of foreign tax or if it was earned in a particular designated jurisdiction. Relief is already provided under Canada's FAPI rules for foreign taxes paid in respect of FAPI (and also would have been provided for under the FIE regime upon a distribution of FIE income, had the proposed new rules been enacted as drafted). Thus, such an exemption should be revenue-neutral while presumably easing compliance and administration for taxpayers and the CRA.

4.131 The Panel identified some potential problems with this approach. First, it may be necessary for taxpayers to ensure that the passive income has been subject to foreign tax, which may not reduce complexity as intended. Secondly, if establishing whether the passive income was actually subject to a certain level of foreign tax were not required, there would be an incentive to move passive investment assets to high-tax foreign countries where the passive income could be sheltered by active business losses or by tax avoidance transactions not subject to anti-avoidance rules.

4.132 The Panel nonetheless believes this approach deserves further consideration, particularly if the FAPI regime is extended to non-controlled foreign affiliates. Such treatment could greatly reduce the compliance and administrative burden for taxpayers and the CRA, especially where, for example, the foreign entities reside in the United States. This approach would also free the CRA to focus more on passive income earned by foreign entities in low-tax jurisdictions.

De minimis rule

4.133 Under the current rules, a Canadian shareholder of a controlled foreign affiliate that earns up to $5,000 of FAPI is not subject to Canadian tax on an accrual basis.

4.134 The de minimis exception under the FAPI regime is a bright-line test that reduces the compliance burden for all businesses, especially small businesses. It prevents the FAPI rules from applying to foreign affiliates that conduct genuine businesses abroad but derive only small amounts of passive income as part of that business. It also allows the CRA to focus its risk assessment and enforcement activities on businesses that earn material amounts of FAPI.

4.135 Other countries, including the United States, the United Kingdom, Germany and Australia, exclude a de minimis amount of passive income of a controlled foreign corporation from accrual basis taxation.

4.136 The Panel believes that a de minimis exclusion is appropriate and that Canada should retain its current approach because of the simplicity and certainty it provides to Canadian businesses. The threshold has not increased since its introduction in the mid-1970s. The Panel heard that the de minimis threshold should be higher, and the Panel believes increasing the threshold would help smaller businesses with foreign operations.

4.137 The Panel considered whether the de minimis threshold should be indexed to inflation. Although indexation would be consistent with Canada's general tax policy, it would add a degree of complexity. The Panel does not recommend that the threshold be indexed each year; however, the threshold should be reviewed periodically to ensure it continues to meet its policy objectives. At this time, the Panel encourages the government to increase the de minimis threshold.

4.138 The Panel also believes that serious consideration should be given to providing a de minimis threshold in the context of the FIE and NRT regimes. Such an exemption could apply to an investment that is less than a certain dollar amount.

Expenses incurred to earn foreign-source income

Introduction

4.139 Under any tax regime that exempts foreign active business income from domestic taxation, it is necessary to ensure that such income is properly measured. For example, Canada's FAPI regime must ensure that passive-type income is not included in the computation of foreign active business income. A more difficult issue in measuring foreign active business income is the treatment of expenses incurred by a domestic company that may be considered to relate, directly or indirectly, to the earning of foreign active business income.

4.140 This section focuses primarily on interest expense incurred by Canadian companies to invest in foreign affiliates. It also addresses the treatment of interest expense in the context of outbound financing arrangements; these so-called double-dip financing arrangements enable interest expense to be deducted in two jurisdictions while the offsetting interest inclusion is taxed elsewhere at a lower rate, or not at all. Later in this section we consider the tax treatment of expenses other than interest.

Treatment of interest expense

4.141 In reviewing this contentious area of international taxation, the Panel assessed several concepts applicable to the treatment of interest expense and considered Canada's historical policy objectives. As noted at paragraphs 3.5 and 3.6 and as embodied in the principles enunciated at paragraph 3.3, Canada's goal has been to achieve a tax system that does not harm the competitiveness of Canadian businesses when investing abroad, accords with international norms, and protects the Canadian tax base. The Panel also considered the impact of the recent global financial crisis on Canadian businesses.

4.142 Current Canadian income tax rules permit the deduction of interest incurred by a Canadian resident taxpayer with respect to funds borrowed to invest or acquire shares in a domestic or foreign company, even though dividend income earned on such shares may not be subject to Canadian tax. Many countries have a similar general rule. In this section, we explore the tax policy basis for the treatment of interest arising from arm's-length debt where the proceeds are invested in foreign companies and through outbound financing arrangements.[57]

4.143 The deductibility of interest expense for Canadian tax purposes on amounts borrowed to invest in foreign affiliates and finance foreign acquisitions is especially challenging. For example, one view is that it is consistent with the matching principle to deny deductions on interest incurred to make outbound investments that will yield dividend income not subject to domestic tax.[58] Another view is that outbound investment increases domestic investment and the domestic tax base overall,[59] and so the additional tax revenues that result provide a basis to support the deductibility of interest incurred to invest abroad.

Other countries' approaches

4.144 Many countries are devoting more attention to the deductibility of interest in general.

> The increase in interest deductibility limitations is mostly driven by (a) academics' recommendations that debt and equity financing be treated equally; (b) the European Court of Justice (ECJ) requirement to treat equally domestic and foreign borrowing and use of borrowed funds; (c) tax collectors' increasing fear of tax base erosion; and (d) a tendency to massively reduce statutory tax rates while broadening the tax base. With regard to tax base erosion, in particular extremely leveraged and often hybrid financing of private equity acquisitions is targeted by tighter interest deduction rules.[60]

57 This section of the report does not address non-arm's-length borrowings or the limited circumstances in which certain anti-avoidance rules could apply. For example, Canada has a targeted anti-avoidance rule that could apply where a taxpayer borrows funds in "weak currency" and converts those funds into another currency that is used to earn income.

58 James R. Hines Jr., *The Tax Treatment of Expenses Incurred to Earn Foreign Source Income: Principles, Policies and Options* (August 2008), research paper prepared for the Advisory Panel on Canada's System of International Taxation.

59 James R. Hines Jr., "Reconsidering the Taxation of Foreign Income", paper presented at the 38th Annual Spring Symposium and State-Local Tax Program of the National Tax Association held in Washington, D.C. on May 15-16, 2008, at p. 22.

60 Pascal Hinny, "New Tendencies in Tax Treatment of Cross-Border Interest of Companies", *Cahiers de droit fiscal international* (vol. 93b), 2008 Brussels Congress of the International Fiscal Association (IFA), General Report (Rotterdam: Sdu Fiscale & Financanciële Uitgevers, on behalf of IFA, 2008), at p. 24.

4.145 Many of the recent changes in European Union (EU) countries in this area stem from a need to accommodate decisions of the ECJ. The ECJ has held that under EU law the tax systems of the EU countries must not discriminate against investments in other EU countries. For example, rules that permit an interest deduction on money borrowed to invest in shares of a domestic company but restrict an interest deduction on money borrowed to invest in another EU company do not accord with EU law.[61] For the same reason, thin capitalization regimes that apply only to domestic companies under foreign control also contravene EU law.[62]

4.146 Some countries that use the Credit Method, including the United States and the United Kingdom, neither immediately nor specifically restrict the deductibility of interest expense incurred to earn income from a foreign company. Under U.S. law, costs incurred to earn foreign-source dividends are allocated to that income in determining how much foreign tax can be claimed as a credit against domestic tax when dividends are received in the United States from foreign affiliates. Although the amount of foreign tax that can be claimed as a credit is indirectly limited by the allocation of previously deducted interest to the foreign-source dividend, interest on money borrowed to invest in foreign companies is deductible for U.S. tax purposes on a current basis without restriction.

4.147 Moreover, the foreign tax credit limitation is not relevant as long as the foreign-source income is not repatriated. Prolonged deferral in paying dividends allows U.S. businesses to achieve a result comparable to what is available to Canadian businesses under Canada's current system.

4.148 Some countries with exemption systems, such as France, the Netherlands and Sweden,[63] do not restrict deductions for interest on arm's-length borrowings invested in foreign company shares that will produce exempt dividend income. However, France exempts only 95 percent of foreign qualifying dividends — the other five percent is considered to be a proxy for expenses incurred that relate to such income. A recent announcement by the Norwegian government proposes to exempt 97 percent of foreign qualifying dividends.[64]

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61 *Bosal Holding BV v. Staatssecretaris van Financiën* (No. C-168/01), [2003] ECR I-09409.

62 *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt* (No. C-324/00), [2002] ECR I-11779. For a statement about the consequences to EU member states applying thin capitalization rules, see "C.F.E. Comments on *Lankhorst-Hohorst GmbH*, C-324/00", submitted by the Confédération Fiscale Européenne to the Council, the European Commission, the European Parliament and the European Court of Justice in 2003.

63 Sweden's latest proposals would deny interest deductions on loans from affiliated companies in cases where the loans are for the acquisition of shares from an affiliated company. Under these revised proposals, interest arising from intra-group loans for the acquisition of shares directly from external parties would not be affected nor would interest on loans from arm's-length persons. For details, see Ernst & Young LLP, *International Tax Alert* (26 August 2008); and KPMG Bohlins AB, *KPMG TaxNews*, issue no. 10 (August 2008) and issue no. 14 (September 2008).

64 Royal Norwegian Ministry of Finance, National Budget 2009, presented to the Storting as Report no. 1 (2008-2009) (October 7, 2008). For summaries of this budget's international tax proposals in English, see PricewaterhouseCoopers LLP, International Tax Services – European Tax, *Newsalert* (October 9, 2008) and *Tax Notes International* (October 13, 2008), at p. 113.

4.149 Some countries allow deductions for interest, subject to general interest-deductibility restrictions that can apply to arm's-length interest paid on money borrowed to invest in foreign affiliates. For example, Australia has introduced a regime that applies to all debt of foreign-controlled Australian companies as well as Australian companies with foreign subsidiaries. Germany has introduced earnings stripping rules which can apply to arm's-length interest on borrowed money used to invest in foreign companies.

Lessons from other countries

4.150 In short, the Panel's benchmarking shows that many countries permit an interest deduction on money borrowed for foreign investment. The following comments aptly summarize what we found in our research and heard in our consultations.

> Canadian companies compete against enterprises based in countries whose international tax systems accommodate double dips and contain other mechanisms that facilitate lower effective tax rates on foreign earnings. Although some countries have introduced a comprehensive interest deductibility rule (e.g., Australia, Germany), it is not yet a widespread development. If more countries shifted their tax systems to this type of rule, and if the United States tightened its international tax system, Canada might then consider similar changes. In the meantime, there is little to be gained by moving early.[65]

4.151 The Panel recognizes that permitting a deduction for interest expense to earn exempt foreign dividends may not be consistent with the matching principle. Nonetheless, for competitiveness reasons, the approach of permitting the deduction has been accepted within the Canadian system for many years.

> (I)nternational norms are largely responsible for the policy not to specifically restrict the deductibility of interest expense on money borrowed to invest in a foreign affiliate. Ultimately, Canada finds itself in the position of having to balance tax theory with the economic realities of the international marketplace…. (T)he government's policy has generally been to favour competitiveness concerns over those of revenue generation.[66]

4.152 Perhaps more importantly, the international financial market outlook has changed dramatically since August 2007. The world faces unprecedented challenges, particularly regarding credit, liquidity and market risk. Many economies are in or are threatened by what is possibly one of the most serious recessions in recent memory. Many governments have felt compelled to intervene in their free market economies. While Canada's prudent regulatory and fiscal policies have enabled the nation to avoid the worst of these difficulties, we are not immune from spillovers from jurisdictions that have suffered more severely. As a result, Canadian businesses face credit and other challenges to their ability to compete outside Canada and invest in future growth.

65 Submission of Deloitte & Touche LLP to the Advisory Panel on Canada's System of International Taxation, at p. 9.

66 Response from the Department of Finance to the Auditor General, Report of the Auditor General 1992, Chapter 2, "Other Observations".

4.153 The guiding principles of tax policy are not dependent on the ebb and flow of the marketplace. Canadian businesses must compete in global markets at all times; however to hobble their ability to compete and invest in the future at the worst of times would not be consistent with the principles guiding our analysis. It is clear that businesses in many of Canada's trading partner nations are not restricted in their ability to deduct interest expenses incurred to invest in foreign affiliates and use various outbound financing arrangements as discussed later in this section.

4.154 The Panel believes that the principles of competitiveness and benchmarking set out in Chapter 3 continue to provide guidance in these times of international economic stress. Prudent policy, cautious stewardship, and management of the risks to the Canadian economy that are within the federal government's ability to act on, are also critical. The success of Canadian businesses operating abroad, and the Canadians they employ, must be considered when making choices about tax measures that could undermine the ability of these businesses to compete.

4.155 For these reasons, the Panel does not believe that there should be any restrictions on the deductibility of interest expense incurred by Canadian companies to invest in foreign affiliates.

Outbound financing arrangements

4.156 This section deals with interest deductibility in the context of outbound financing arrangements. These arrangements are widely used by multinational companies to structure their international investments. They are designed to efficiently finance acquisitions and expansion abroad and can lead to low foreign tax rates on specific sources of foreign income. Recently, Canada passed new targeted legislation[67] that aims to curtail the use of such structures by Canadian companies.

4.157 Some tax policy specialists argue that rules aimed at eliminating double-dip structures are inappropriate, because these financing arrangements reduce foreign tax payable, not Canadian tax. On this view, Canadian tax policy should focus on measuring and taxing Canadian source income, and the Panel has focused on this point. Others argue that such rules are important for ensuring that Canadian domestic investment does not bear a higher tax cost than foreign investment. The Panel believes these issues should be addressed pragmatically and with guidance from the principles regarding competitiveness and benchmarking set out in Chapter 3.

4.158 The United States has introduced new rules that affect interest deductions for cross-border investments. These "dual consolidated loss" rules address a broad range of situations where a single economic loss is deducted twice. In 2005, the United Kingdom introduced "anti-arbitrage" rules targeting structures involving hybrid entities and hybrid instruments. The scope of the UK rules is broad, and they can apply to certain outbound financing structures.[68]

67 Section 18.2 of the Act.

68 HM Revenue and Customs, "Avoidance Involving Tax Arbitrage", guidance on the Finance (No. 2) Act 2005, at pp. 5-8.

U.S. Outbound Financing Arrangements

The U.S. tax rules enable outbound international financing structures through two ways: the "check-the-box" rules and the "look-through" rule.

U.S. check-the-box rules

The check-the-box rules allow foreign companies to be treated as transparent entities so that payments between two foreign companies are non-events for U.S. tax purposes. For example, interest received by a foreign company under the control of a U.S. parent is normally treated as passive income and may be taxed on a current basis to the U.S. parent, similar to the way FAPI is taxed in a Canadian context. If the foreign payer and the foreign recipient are treated as transparent entities or "branches" of one corporation because of the check-the-box rules, no interest is received (because a corporation cannot transact with itself) and thus no passive income is attributed to the U.S. parent.[69] *These check-the-box rules can facilitate the use of outbound cross-border financing arrangements.*

U.S. look-through rule

The look-through rule is an exception to the U.S. passive income regime, which is similar to Canada's FAPI exception for certain inter-affiliate payments. This U.S. rule does not treat as passive income certain payments such as interest where the payment can be deducted from the payer's active business income. This rule makes structured outbound financing even easier for U.S.-based multinationals by eliminating the need to create and select entities that are eligible for the check-the-box regime. This rule is a temporary one and was recently extended to December 31, 2010.

UK Outbound Financing Arrangements

Unlike Canada's FAPI regime, which is based on transactions, the United Kingdom's controlled foreign corporation (CFC) regime is entity-based. Under Canada's system, if a controlled foreign affiliate derives income from a passive source, only that source of income is attributed to the Canadian shareholder. Under the UK system, if the foreign corporation is determined to be carrying on a principally passive activity, then all of that entity's income is attributed to the UK shareholder. However, if the entity is classified as carrying on predominantly an active business, none of its passive income is attributed to the UK shareholder. Thus, UK-based multinationals can organize structured outbound financing arrangements by using foreign companies that carry on predominantly active businesses to finance other companies within the group.[70]

69 See United States, Joint Committee on Taxation, *The U.S. International Tax Rules: Background and Selected Issues Relating to the Competitiveness of U.S. Businesses Abroad*, July 15, 2003, p. 34. While the U.S. government has at times suggested these arrangements would be curtailed (see, for example, Notice 98-11, 1998-6 I.R.B. 18 (January 16, 1998) and Notice 98-35, 1998-27 I.R.B. 35 (June 19, 1998)), this has not occurred (see Internal Revenue Bulletin No. 999-30 (July 26, 1999)). In any event, the adoption of the temporary look-through rule discussed above suggests that such planning remains acceptable.

70 The UK government is aware of such planning and is consulting with business about the reform of the entire UK system for taxing foreign-source income. See the HM Treasury Technical Note, available at www.hm-treasury.gov.uk/d/foreignprofits_technicalnote210708.pdf

4.159 However, for companies based both in the United States and the United Kingdom, these rules do not result in the elimination of such arrangements and U.S. and UK-based companies can still make use of tax-effective outbound financing arrangements. While there are likely many different ways in which companies based in these two countries can structure outbound financing arrangements, the box on the previous page provides some examples.

4.160 The Panel has noted recent tax treaty developments that aim to deny the benefits of certain cross-border financing arrangements. For example, in 2001, the United States and the United Kingdom agreed to a provision in their tax treaty to reduce the effectiveness of certain financing transactions used by UK companies to finance their U.S. operations.[71] More recently, the fifth protocol to the Canada-U.S. tax treaty[72] introduced rules that reduce the effectiveness of certain cross-border financing arrangements. Despite these measures, cross-border financing arrangements remain possible between the United Kingdom and the United States and between the United States and Canada.

4.161 Other countries, such as the Netherlands and Sweden, do not have any targeted domestic measures to restrict interest expense where money is borrowed from an unrelated party for use in outbound financing arrangements.

4.162 Foreign affiliate regimes that are tightly controlled can be viewed as substitutes for targeted interest restriction rules. For example, France's controlled foreign corporation (CFC) regime attributes all the income of a foreign entity to the French parent where the foreign entity is subject to a tax rate that is 50 percent or less than France's rate on similar income.[73] At first glance, such a system would seem to deter the use of outbound structured financing arrangements. However, the French CFC regime does not apply to a foreign entity established or resident in an EU Member state. Thus, French CFC rules may not apply to an Irish entity that may be taxed at a rate which is less than 50 percent of France's 33.33 percent corporate tax rate. An exception allows the French tax authorities to apply the CFC rules if they can show that the establishment in the other EU state is an artificial scheme designed to skirt French tax law.[74] However, based on recent ECJ decisions, it may be relatively easy for companies to stay clear of what is considered "artificial".[75]

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71 Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains, signed at London, UK on July 24, 2001 (the "U.S.-UK tax treaty"), as amended, article 24(4)(c).

72 Convention Between Canada and the United States of America With Respect to Taxes on Income and on Capital, signed at Washington, D.C. on September 26, 1980 (the "Canada-U.S. tax treaty"), as amended by the Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995 and July 29, 1997. The treaty was further amended by a Protocol signed September 21, 2007 (the "fifth protocol"). See articles IV(6) and (7) of the Canada-U.S. tax treaty as amended by the fifth protocol.

73 Deloitte & Touche LLP, *Tax Treatment of Expense Attributable to Foreign Source Income in Selected Countries* (May 2008), report prepared for the Advisory Panel on Canada's System of International Taxation.

74 Ibid.

75 In *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd. v. Commissioner of Inland Revenue* (C-196/04), a UK public company, Cadbury Schweppes plc, established subsidiaries in Ireland, which benefited from a low-tax (10 percent) regime, for the purpose of performing group financing functions. The ECJ held that the UK CFC regime should not apply where a CFC located in another EU member state (i.e., the Irish subsidiaries) carries on genuine economic activities, despite the existence of tax-driven motives. The ECJ held that CFC rules could apply to foreign subsidiaries where the arrangement was wholly artificial.

4.163 It is clear that other countries have not eliminated the use of outbound financing arrangements. Competitors of Canadian businesses based in other countries are able to make use of such arrangements to finance foreign acquisitions and expansions tax-effectively.

Conclusion

4.164 Interest deductibility was raised as an issue at every consultation meeting and in many submissions to the Panel. Members of the business community strongly oppose any restriction on interest expense incurred to invest in foreign affiliates.

4.165 Our research shows that many businesses based in other countries can deduct interest on money borrowed to invest in a foreign company even though dividends from the foreign company, when repatriated, will be either exempt or mostly free from home country tax. While some countries have introduced targeted rules aimed at restricting outbound financing arrangements, many such arrangements remain widely available. The Panel believes that Canada's tax system should not create disadvantages for Canadian businesses when they compete abroad.

4.166 Canadian businesses need flexibility in raising capital and structuring the financing of their foreign acquisitions and expansions to be competitive with businesses based in other countries. In the Panel's view, this pragmatic concern is of greater weight than the theoretical basis for denying interest deductions on money borrowed to invest in foreign companies or in respect of outbound financing arrangements.

4.167 As noted at paragraphs 4.152–4.154, events in the current global financial environment highlight how quickly capital markets can change and how adaptable Canadian companies need to be. Since summer 2007, the manner in which financial market participants evaluate credit, liquidity and market risk has shifted dramatically. Due to changes in the conditions that affect capital markets for Canadian and global businesses, debt placement is much less flexible. The Panel acknowledges that although arguments exist for rules that deny interest deductibility on borrowings related to investments in foreign affiliates or in respect of outbound financing arrangements, now is not the right time to impose rules that could restrict access to capital for Canadian companies, especially when international tax rules in many other countries support the deductibility of interest for investments and arrangements.

RECOMMENDATION 4.7: *Impose no additional rules to restrict the deductibility of interest expense of Canadian companies where the borrowed funds are used to invest in foreign affiliates and section 18.2 of the Income Tax Act should be repealed.*

Treatment of expenses other than interest

4.168 For Canadian tax purposes, a business can deduct reasonable expenses in computing its income only to the extent they are incurred to earn or maintain such income, subject to certain exceptions and conditions.

4.169 Often one member within a corporate group will incur general and administrative expenses (including stewardship costs) and other costs related to services it provides for the group's benefit. The member cannot deduct from its income expenses that it incurred that should be reimbursed by others in the group. Thus, the payer will either on-charge the expenses to the companies that benefited from the services or will enter into cost-sharing arrangements at the outset if the benefits (or risks) of the expense are mutual (for example, when sharing research and development costs). Such charges usually include all direct and indirect costs, and they may be marked up or computed using a formula.

4.170 These general and administrative expenses relate to a range of services from human resources to advertising and insurance. Their recovery can be complex, but the approach to their recovery is simple: those who benefit from the expenses incurred by another must pay for them to the extent of that benefit. This approach protects Canada's tax base by preventing a tax deduction to the extent that the expenses do not relate to the business activities of the person that incurred the cost, thereby ensuring that person's income is properly measured.

4.171 Canada's rules for recovering expenses other than interest appear to operate reasonably well. Moreover, most countries that use an exemption method take a similar approach: such expenses are deductible if they are incurred to earn or maintain taxable income, and there are no detailed tracing or allocation rules to determine if these expenses relate to exempt foreign-source dividends and capital gains.[76]

4.172 Like Canada, these other countries rely on their general approach and on their transfer pricing rules, which require that intra-group charges reflect arm's-length pricing to properly measure domestic source income. This is largely a transfer pricing issue and is addressed in Chapter 7.

4.173 The Panel has concluded that Canada's current tax treatment of intra-group expenses works reasonably well and sees no compelling reason for additional rules.[77]

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76 A few countries that use the territorial method, such as France, Germany and Italy, impose rules on the disposition of affiliates and receipt of dividends that effectively recapture a small percentage of deducted expenses. Countries that employ a credit method tend to have allocation or formulary apportionment rules for expenses related to foreign-source income, which are used in foreign tax credit calculations. How these rules operate to indirectly limit interest expense are discussed at paragraphs 4.146-4.147.

77 The Technical Committee on Business Taxation reached the same conclusion. See *Report of the Technical Committee on Business Taxation*, at p. 6.19.

5. Taxation of Inbound Direct Investment

Introduction

5.1 As noted in Chapter 2, direct investment in Canada by foreign businesses is important to Canada's prosperity. Inbound foreign direct investment stimulates business activity and creates jobs in Canada. It fosters competition, facilitates the importation of new technology and skills, and contributes to the growth and productivity of Canada's economy.

5.2 The Panel is guided by the principle described in Chapter 3 that Canada's tax system should seek to treat foreign investors in a way that is similar to domestic investors while ensuring that foreign companies investing in Canada pay an appropriate amount of Canadian tax on their Canadian-source income.

5.3 In this chapter, we address two important aspects of Canada's system for taxing foreign inbound investment: the tax treatment of interest expense incurred by foreign-owned Canadian businesses and access to Canada's tax treaty network by foreign investors. Both aspects present challenges in ensuring foreign and Canadian investors are treated similarly while protecting the integrity of Canada's tax base. The Panel recognizes that the playing field can never be perfectly level. For example, some non-resident investors could structure the financing of their investments into Canada in a more tax-effective way than could Canadian domestic investors. The Panel's pragmatic approach was to focus on the tax consequences arising within the Canadian tax system and not on the tax consequences in other jurisdictions. Canada's withholding tax regime — a third area affecting foreign inbound taxation — is discussed in Chapter 6.

Interest expense incurred by foreign-owned Canadian businesses

Canada's approach

5.4 Foreign businesses investing in Canada typically have the flexibility to choose between debt and equity in financing their Canadian subsidiaries. Using related-party debt rather than equity allows a foreign business to reduce its overall tax burden to the extent that the interest paid by the Canadian subsidiary is deductible in Canada at a higher tax rate than the rate at which the interest is taxed in the parent company's or related company's home country. Without any restrictions, a foreign business could leverage its Canadian subsidiary entirely or mainly with debt, thereby eliminating or significantly reducing the amount of tax the subsidiary would otherwise pay in Canada.

5.5 To address this concern, Canada has adopted rules — known as "thin capitalization" rules — to limit the erosion of the Canadian corporate income tax base from deductions claimed by foreign-owned Canadian corporations regarding interest paid on loans from related non-residents. Under these rules, interest paid by a Canadian corporation on loans received from certain non-resident persons[78] is not deductible to the extent that such loans exceed twice the equity (computed under special rules) of that corporation.

5.6 These rules do not apply to loans received from third-party lenders, whether Canadian or foreign, including loans guaranteed by a related foreign company. Interest expense denied under these rules cannot be carried forward for use in future years.

5.7 In the early 1970s, Canada became one of the first countries to adopt thin capitalization rules. The Panel believes that Canada's current approach has stood the test of time and works well: it is effective, transparent and relatively simple to administer and comply with. Many other developed countries also restrict the amount of interest paid on related-party debt that a foreign-owned corporation can deduct, although some of these countries use different approaches. Many countries also restrict interest paid on other forms of debt, as discussed below.

5.8 The Panel believes Canada's current approach should be maintained. In the course of our review, the Panel noted some specific issues, discussed below, which should be addressed to ensure the system remains effective in protecting Canada's tax base.

Other countries' approaches

5.9 Other countries face similar challenges in protecting their domestic tax bases, and many significantly changed their treatment of interest expense in recent years. While some countries, like Canada, impose limits on related-party indebtedness that are based on fixed debt-to-equity or debt-to-assets ratios (for example, Australia, Japan, the Netherlands and New Zealand), others impose different restrictions on related-party debt financing (sometimes together with a fixed-ratio limit).[79] These approaches and their possible application to Canada are discussed below.

78 Canada's thin capitalization rules apply to Canadian corporations that have debts owing to "specified non-resident shareholders" or to non-resident persons that do not deal at arm's length with specified shareholders. A specified shareholder is a shareholder who, either alone or together with persons with whom the shareholder is not dealing at arm's length, owns shares of the Canadian corporation representing 25 percent or more of its votes or value. In this report, Canadian corporations that are subject to the thin capitalization rules are referred to as "foreign-owned".

79 A few countries, notably Finland and Sweden, have no thin capitalization rules at all. Sweden is currently considering whether to adopt some form of limitation on interest deductibility. See footnote 63 on page 48.

Earnings stripping rules

As an alternative to a fixed-ratio approach, some countries have adopted "earnings stripping" rules. Under this approach, the amount of related-party interest that a foreign-owned corporation can deduct is limited to a percentage of that corporation's earnings before interest, tax, depreciation and amortization. The United States was among the first countries to adopt such an approach, with rules enacted in 1989. Denmark, France, Germany and Italy recently adopted similar rules.

The merit of earnings stripping rules is that they target interest deductions — and related tax planning — more directly than the balance sheet approach used in thin capitalization regimes. Earnings may be better than equity as a proxy for a firm's borrowing capacity; equity is typically valued at historical cost and does not reflect current profit expectations. For that reason, a limitation based on earnings would treat similarly situated taxpayers more consistently and could better accommodate industries with higher degrees of leverage.

However, earnings stripping rules tend to be more complicated than fixed-ratio approaches. Adopting an earnings stripping rule in Canada would be particularly complex given that Canada does not have a consolidation regime for tax purposes.[80] Earnings stripping rules also can adversely affect cyclical businesses by limiting their ability to deduct interest expense during economic downturns. While carryover provisions could be adopted to mitigate these adverse effects, more complexity in the rules would result.

Arm's length approaches

Under another alternative, some countries apply transfer pricing principles to determine how much related-party debt of a foreign-owned subsidiary is appropriate. For example, the United Kingdom denies deductions for interest paid by corporations on related-party loans to the extent that the loans exceed what those corporations could have borrowed from third-party lenders. Other countries, such as Australia, do not restrict interest deductibility under their thin capitalization or earnings stripping rules if the corporation can demonstrate that it could have borrowed the same amount from arm's-length lenders. Also, a foreign-owned Japanese corporation can exceed Japan's maximum allowable 3:1 debt-to-equity ratio if other Japanese corporations in a similar business and of a similar size carry higher debt-to-equity ratios.

80 For example, there may be situations where the financing operations within the same corporate group are separated from the income-earning activities. Absent tax consolidation, the overall amount of interest deductible by the group could be smaller if the income earned by some members of the group is not accounted for in determining how much interest can be deducted by the other group members. Rules would be needed to prevent such an outcome. Such rules could involve a mechanism to allow for the transfer of excess "earnings stripping" capacity within a corporate group.

5.14 The merit of an arm's length approach is that it considers the corporation's specific situation in determining how much interest the corporation can deduct. In contrast, under Canada's current thin capitalization regime, foreign-owned Canadian corporations are subject to the same maximum debt-to-equity ratio regardless of their size, profitability or line of business.

5.15 On the other hand, the arm's length approach would be more difficult and costly to comply with and administer, as foreign-owned Canadian corporations would have to demonstrate to the CRA that their level of debt meets the arm's-length test. This approach could cause uncertainty because it would likely be difficult for the government to provide clear and timely guidance on exactly what constitutes an arm's-length amount of debt. Canada's bright-line test of how much related-party debt a foreign-owned corporation can borrow offers greater certainty to businesses, and is simpler and easier to administer.

Third-party and guaranteed debt

5.16 Rules to limit interest deductibility also differ as to the type of debt to which they apply. Canada's current thin capitalization rules only apply to related-party debt. In recent years, an increasing number of countries have extended thin capitalization or earnings stripping rules to cover third-party debt as well as related-party debt.

5.17 New Zealand introduced rules which took effect in 1996 that limit interest deductions on related and third-party debt to the higher of 75 percent of a corporation's total assets and 110 percent of the debt-to-asset ratio of the corporation's worldwide group. Australia adopted a similar regime in 2001.

5.18 Germany adopted an earnings stripping rule in 2008 that limits the interest expense claimed by a German resident company where the company's total net interest expense exceeds 30 percent of its taxable earnings before interest, taxes, depreciation and amortization. This restriction applies to interest paid on any debt of a taxpayer, as long as the taxpayer is a member of a corporate group. Denmark and Italy have adopted similar earnings stripping rules in the last two years.

5.19 France and the Netherlands do not restrict the amount of interest paid on third-party debt that a corporation can deduct, but they do take into account how much third-party debt has been borrowed to determine whether to restrict deductions for related-party interest expense.

5.20 A few other countries, including the United States, the United Kingdom, Japan and the Netherlands, allow deductions for interest paid to third-party lenders but restrict interest paid on third-party debt that is guaranteed by a foreign parent company ("guaranteed debt").

5.21 Some of the above countries, notably Australia, New Zealand and many European jurisdictions, extend the scope of their rules beyond foreign-owned businesses to domestic companies with foreign operations or even to all companies. EU countries have been extending their rules to both domestic and foreign-owned companies to ensure they are in line with EU law regarding non-discrimination and the free movement of capital within the EU.[81]

5.22 Based on the Panel's benchmarking research, Canada now appears to be one of the few developed countries to apply thin capitalization rules to related-party debt only. The Canadian government proposed to extend the thin capitalization rule to guaranteed debt in the 2000 federal budget, but this proposal was later withdrawn.[82] Recently, two Canadian international tax experts called for Canada to adopt a comprehensive domestic thin capitalization rule that would apply to all indebtedness of all Canadian corporate groups, and not just to foreign-owned Canadian corporations.[83]

5.23 The policy case for limiting interest deductions on these forms of indebtedness is mixed. In some circumstances, third-party and guaranteed debt can substitute for related-party debt and can be sourced out of Canada to produce a higher interest deduction in Canada. To that extent, foreign businesses can use both related-party and third-party debt to leverage their Canadian operations. However, other non-tax considerations can restrict how much third-party and guaranteed debt a foreign-owned Canadian corporation can borrow.[84] Related-party debt and third-party debt are less-than-perfect substitutes, which may act as a constraint that lessens the need to impose limits on third-party debt.

5.24 There is little evidence that Canada's income tax base is at risk from the use of third-party and guaranteed debt by non-financial foreign-owned Canadian corporations. At the industry level, enterprises under foreign control do not appear to be significantly more indebted than enterprises under Canadian control. Table 5.1 shows the total assets in non-financial industries of enterprises under foreign control, categorized by the magnitude of the difference at the industry level between the debt-to-equity ratio of foreign-controlled enterprises and the debt-to-equity ratio of Canadian-controlled enterprises. On average, industries where the aggregate debt-to-equity ratio of foreign-controlled enterprises is no greater or at most 10 percent greater than the aggregate debt-to-equity ratio of Canadian-controlled enterprises account for three-quarters of all assets of foreign-controlled enterprises.[85]

81 See, for example, ECJ, *Lankhorst-Hohorst GmbH*, C-324/00. See paragraph 4.145 and related footnotes.

82 Department of Finance Canada news release 2000-039, "Finance Minister Clarifies Certain Income Tax Measures in the 2000 Budget" (May 9, 2000).

83 Allan R. Lanthier and Jack M. Mintz, "Seeking a More Coherent Approach to Interest Deductibility", *Canadian Tax Journal*, vol. 55(3) (2007), at pp. 629-654.

84 Tim Edgar, *Interest Deductibility Restrictions and Inbound Direct Investment* (October 2008), research report prepared for the Advisory Panel on Canada's System of International Taxation.

85 For example, a debt-to-equity ratio of 1.24 would be 10 percent greater than the all-industry average debt-to-equity ratio of 1.13 for Canadian-controlled enterprises.

Table 5.1

Distribution of Assets in Non-financial Industries of Enterprises Under Foreign Control

	Billions of dollars						Percentage of assets					
	2000	2001	2002	2003	2004	2005	2000	2001	2002	2003	2004	2005
TOTAL	**456**	**518**	**526**	**560**	**586**	**609**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
D/E ratio of FCEs is equal or lower than D/E ratio of CCEs	201	385	204	141	315	178	44.1	74.3	38.9	25.2	53.8	29.2
D/E ratio of FCEs is at most 10% greater than D/E ratio of CCEs	166	2	168	290	107	299	36.4	0.4	31.9	51.8	18.3	49.1
D/E ratio of FCEs is more than 10% greater than D/E ratio of CCEs	77	121	136	117	154	121	16.9	23.4	25.8	21.0	26.2	19.9
D/E ratio not available	12	10	18	11	10	11	2.6	1.9	3.4	2.1	1.7	1.8

Note: This table shows the breakdown of total assets of enterprises under foreign control in non-financial industries, according to the magnitude of the difference between the industry-level debt-to-equity ratio (D/E ratio) of foreign-controlled enterprises (FCE) versus Canadian-controlled enterprises (CCE). The debt-to-equity ratio is calculated as the ratio of short-term loans and long-term loans and debt on total shareholders' equity.

Source: Calculations based on a special tabulation obtained from Statistics Canada using data from the Financial and Taxation Statistics for Enterprises program.

5.25 Restricting the use of third-party or guaranteed debt would increase the complexity of the current system and the compliance burden of businesses. Unlike most developed countries, Canada does not permit consolidated reporting for tax purposes. Rather, all members of a corporate group compute their tax liabilities and file returns separately. The lack of tax consolidation in Canada would make it difficult to restrict interest deductibility related to third-party or guaranteed debt. For example, a foreign business could set up one Canadian financing company for channelling debt to its Canadian operating subsidiaries. By borrowing from third parties with a parent guarantee, the financing company could exceed a 2:1 debt-to-equity ratio, even though the debt-to-equity ratio of the Canadian consolidated group might be under 2:1. If the rules covered guaranteed debt, additional measures would be needed to ensure that no restriction applies in such situations.

5.26 Another complication would be the need to exclude financial institutions (e.g., banks, non-banks and lessors) from the scope of any such restrictions. Use of third-party and guaranteed debt is within the normal business practices of the financial intermediation sector, and restrictions on such indebtedness could impair the competitiveness of these businesses and limit the ability of foreign-owned financial institutions to service key sectors of the Canadian financing market.

5.27 Having considered whether Canada's thin capitalization rules should apply to third-party and guaranteed debt, the Panel concluded that such restrictions are not required at this time. More specifically, Canada's thin capitalization rules should not be extended to limit the deductibility of interest payable by foreign-owned Canadian corporations

on third-party debt and guaranteed debt, nor should they be modified to take into account third-party and guaranteed debt in determining the amount of related-party interest that a foreign-owned Canadian corporation can deduct.

5.28 Although restricting deductions related to interest paid on third-party and guaranteed debt is not advisable at this time, the government should continue to follow developments in other countries and monitor the use of these forms of debt in Canada to ensure that the existing rules support the proper measurement of Canadian-source business income.

Tightening Canada's thin capitalization regime

5.29 For the reasons discussed above, the Panel believes that Canada's current approach to interest expense incurred by foreign-owned Canadian businesses is sound in principle and appropriate in scope. The approach is transparent and relatively easy to enforce, and the Panel believes it should be maintained.

5.30 Many developed countries have tightened their approaches to thin capitalization in recent years. This trend may reflect the increasing use of cross-border financial transactions and the rising need for governments to take steps to protect their tax bases. In light of ongoing change in the tax environment, business practices and capital markets, Canada's rules should be assessed to ensure they appropriately address the use of related-party debt.

5.31 The central feature of Canada's current thin capitalization regime is the maximum debt-to-equity ratio. Interest on related-party debt of foreign-owned Canadian corporations over this ratio is not deductible. The maximum debt-to-equity ratio was initially set at 3:1 and reduced to 2:1 following the 2000 federal budget.

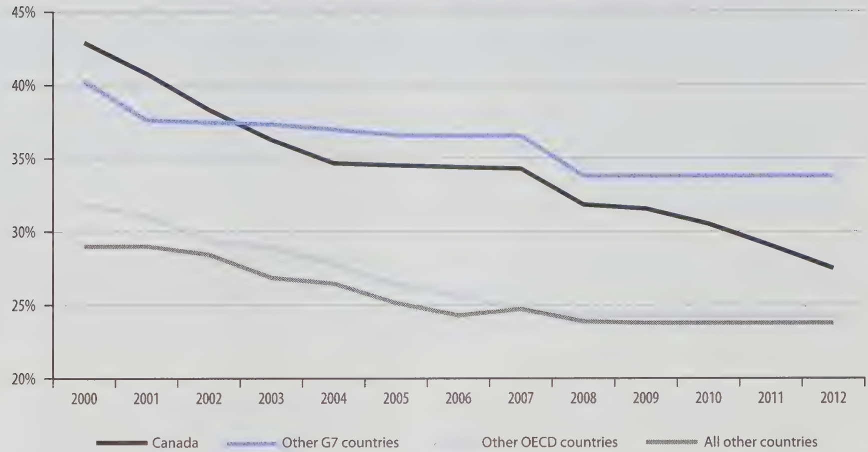
5.32 In our consultation paper, the Panel asked whether the current 2:1 ratio is a good proxy for the amount of related-party debt that a foreign-owned Canadian corporation should be allowed to incur in Canada. Based on our analysis, the Panel has concluded that a more restrictive ratio is appropriate.

5.33 While the planned reductions in Canada's statutory corporate income tax rate will bring many economic benefits, these reductions alone will not be enough to reduce the incentive for foreign businesses to use related-party debt to finance their Canadian subsidiaries for the following reasons:

- The elimination of withholding tax on non-arm's-length interest paid to U.S. residents under the fifth protocol to the Canada-U.S. tax treaty will make it more attractive for U.S.-based corporate groups to finance their Canadian subsidiaries with debt.
- While Canada's rate is expected to be six percentage points lower than the average rate of other G7 countries by 2012, it will still be higher than the rates in many other OECD and non-OECD countries.

Figure 5.1

Statutory Corporate Income Tax Rates in Canada versus Other Countries, 2000–2012



Note: The federal government has set a target to achieve a combined federal-provincial corporate rate of 25 percent by 2012, which would require changes on the part of the provinces to achieve a 10-percent weighted average rate. The chart reflects the 13 percent provincial rate that would be in force by 2012 absent further provincial rate reductions beyond those already announced.

Sources: Department of Finance Canada; KPMG International, *KPMG's Corporate and Indirect Tax Rate Survey 2008.*

- Reducing the corporate tax rate does not discourage certain transactions that allow foreign businesses to gain a significant cost advantage over Canadian-owned companies (i.e., inbound double dips).[86]

5.34 The debt-to-equity ratio permitted under Canada's current thin capitalization rules is relatively high compared to actual Canadian industry ratios, suggesting that the ratio permits inappropriate levels of related-party debt. Accordingly, reducing the current ratio probably should not significantly affect access to capital. As Table 5.2 shows, average industry-level, debt-to-equity ratios over the 2000-2005 period were well under 2:1 in most industries, especially in the non-financial sector. The same is true for enterprises under foreign control.

86 See Bev Dahlby, *Taxation of Inbound Direct Investment: Economic Principles and Tax Policy Considerations* (October 2008), research report prepared for the Advisory Panel on Canada's System of International Taxation, at section 4.

Table 5.2

Assets and Debt-to-Equity Ratio of Canadian Enterprises, by Industry, Average 2000–2005

Industry	Total assets						Debt to equity ratio			
	All enterprises		Country of control				All enterprises	Country of control		
	Billions of dollars	Percentage of total	Billions of dollars			Percentage foreign		Canada	U.S.	Other
			Canada	U.S.	Other					
All industries (excluding management of companies and enterprises)	4,569	100.0	3,636.0	549.6	383.8	20.4	1.12	1.13	1.19	0.95
Non-financial industries										
Manufacturing	633	13.9	350.4	172.1	110.3	44.7	0.63	0.64	0.64	0.62
Oil and gas extraction and support activities	249	5.4	139.8	81.3	27.6	43.9	0.94	0.68	1.64	0.88
Utilities	190	4.2	178.6	11.5	5.0	5.7	3.76	4.08	1.18	1.48
Wholesale trade	171	3.8	110.3	34.4	26.5	35.5	1.12	1.37	0.81	0.71
Information and cultural industries	154	3.4	146.0	5.0	2.9	5.1	1.27	1.26	1.35	2.04
Retail trade	132	2.9	105.9	23.1	3.4	19.9	1.27	1.38	0.82	1.54
Transportation and warehousing	130	2.9	n.a.	n.a.	n.a.	n.a.	1.65	n.a.	n.a.	n.a.
Construction	107	2.3	102.6	2.0	2.7	4.4	1.98	2.06	0.63	0.96
Professional, scientific and technical services	85	1.9	71.4	10.3	3.5	16.2	0.88	0.87	1.14	0.60
Mining and quarrying (except oil and gas)	77	1.7	68.6	n.a.	n.a.	11.3	0.53	0.52	n.a.	n.a.
Agriculture, forestry, fishing and hunting	56	1.2	55.0	0.3	0.7	1.9	1.33	1.33	0.82	3.00
Accommodation and food services	40	0.9	34.3	3.3	2.7	14.9	2.91	3.15	1.40	4.13
Administrative and support, waste management and remediation services	38	0.8	29.3	7.1	2.1	24.3	1.44	1.31	2.16	1.76
Educational, healthcare and social assistance services	26	0.6	26.0	0.4	0.1	1.7	1.03	1.03	0.70	n.a.
Repair, maintenance and personal services	25	0.5	n.a.	n.a.	n.a.	n.a.	0.99	n.a.	n.a.	n.a.
Arts, entertainment and recreation	21	0.4	20.0	0.4	0.2	3.1	1.62	1.61	1.24	4.19
Financial industries										
Depository credit intermediation	1,506	32.9	1,394.9	30.6	80.5	7.4	0.89	0.87	2.96	0.88
Insurance carriers and related activities	322	7.0	211.5	50.4	60.4	34.9	0.17	0.21	0.14	0.04
Other financial industries	225	4.9	195.2	21.5	8.1	13.3	0.61	0.56	1.38	1.01
Real estate and rental and leasing	199	4.4	173.9	17.8	7.3	12.6	2.30	2.19	3.85	3.91
Non-depository credit intermediation	182	4.0	81.6	69.8	30.4	54.7	5.94	5.22	6.50	11.48

Source: Calculations based on a special tabulation obtained from Statistics Canada using data from the Financial and Taxation Statistics for Enterprises program. Debt-to-equity ratios are calculated as the ratios of short-term loans and long-term loans and debt to total shareholders' equity.

5.35 Table 5.3 shows the percentage of the total market capitalization of the 1,000 largest publicly traded Canadian companies by industry, as reported annually by the *Report on Business* magazine. In the 2007 and 2008 surveys, companies with an overall debt-to-equity ratio greater than 2:1 (mostly in the financial sector) accounted for 6.1 and 3.3 percent respectively of the total market capitalization of these 1,000 largest companies.[87] The average debt-to-equity ratio, weighted by market capitalization, was 0.63 in 2007 and 0.59 in 2008.

5.36 Our benchmarking research shows that the currently permitted debt-to-equity ratio in Canada's thin capitalization rules may be high relative to world standards, because the ratios in many other countries apply to third-party and related-party debt. Many countries with ratios equal to or greater than 2:1 apply them to related-party, guaranteed and third-party debt.

Table 5.3

Total Market Capitalization of Top 1,000 Largest Publicly Traded Canadian Companies, by Debt-to-Equity Ratio of Companies, 2007 and 2008

	Percent of total market capitalization of top 1,000 companies									
	2007				2008					
		Debt/equity ratio				Debt/equity ratio			Debt/equity ratio*	
Industry	All companies	≤ 1.5	> 1.5 and ≤ 2	> 2	All companies	≤ 1.5	> 1.5 and ≤ 2	> 2	2007	2008
All industries	**100.0**	**89.1**	**4.8**	**6.1**	**100.0**	**92.3**	**4.4**	**3.3**	**0.63**	**0.59**
Agriculture, fishing and forestry	0.9	0.8	0.1	0.1	0.8	0.7	0.1	0.1	1.06	1.21
Arts, culture and entertainment	0.6	0.5	0.0	0.1	0.6	0.5	0.0	0.1	1.00	0.94
Construction	0.3	0.0	0.0	0.3	0.5	0.1	0.0	0.4	2.30	1.95
Finance, real estate and leasing	31.7	26.8	1.5	3.4	31.0	26.7	2.2	2.2	0.67	0.74
Information and communication	9.0	6.2	1.8	0.9	10.1	9.6	0.4	0.2	1.10	0.78
Manufacturing	6.9	6.1	0.5	0.3	7.7	7.4	0.2	0.1	0.86	0.45
Resources	37.3	37.0	0.2	0.1	36.7	36.6	0.1	0.1	0.37	0.35
Services	6.0	5.7	0.2	0.2	5.6	5.3	0.1	0.1	0.56	0.57
Trade	4.8	4.8	0.0	0.0	4.2	4.1	0.0	0.0	0.64	0.58
Utilities	2.7	1.3	0.5	0.8	2.7	1.2	1.4	0.1	1.47	1.52

* *Weighted by market capitalization.*

Source: Calculations based on *Report on Business*' Top 1,000 Companies database.

87 This information is extracted from financial statements and essentially reflects the total consolidated debt (mostly third-party) incurred by these companies, both in Canada and abroad.

5.37 Although tightening the restrictions on the use of related-party debt might encourage companies to source more of their debt from third parties, such a change would put foreign and Canadian-owned businesses on a more similar footing because foreign businesses would not enjoy any advantage regarding the use of third-party debt.

5.38 Foreign-owned corporations have an incentive to use related-party debt to reduce their Canadian tax liabilities. The above data suggests that the current thin capitalization ratio is not in line with current industry practices or with the rules in place in other countries. For these reasons, the Panel believes that the current maximum debt-to-equity ratio of 2:1 should be reduced.

RECOMMENDATION 5.1: *Retain the current thin capitalization system, and reduce the maximum debt-to-equity ratio under the current thin capitalization rules from 2:1 to 1.5:1.*

Technical issues related to the thin capitalization rules

5.39 In the course of our work, the Panel identified certain technical issues related to the thin capitalization rules that should be addressed. The Panel believes that the measures discussed below would strengthen the integrity of the current regime. Addressing these issues could add complexity to the existing rules, and further study and consultations are needed to gauge the significance of these issues in practice.

Partnerships, trusts and branches

5.40 The current thin capitalization rules apply only to foreign-owned Canadian corporations. Foreign companies that carry on business in Canada through partnerships, trusts or branches are not subject to the same limitation, which raises issues about the integrity and fairness of the current rules.[88] In 1998, the Technical Committee on Business Taxation recommended extending the current rules to partnerships, trusts and Canadian branches of foreign corporations.[89] In the 2000 federal budget, the government said it intended to hold consultations on how best to extend these rules to entities other than corporations. The Panel recommends that these consultations proceed and that the rules be extended to these other business entities.

RECOMMENDATION 5.2: *Extend the scope of the thin capitalization rules to partnerships, trusts and Canadian branches of non-resident corporations.*

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88 The Act contains rules for computing the interest deduction that can be claimed in Canada by a foreign bank that operates a Canadian banking business through a Canadian branch (see section 20.2 of the Act).

89 *Report of the Technical Committee on Business Taxation*, at p. 6.30.

Disallowed interest expense

5.41 Currently, interest expense that is not deductible under the thin capitalization rules maintains its character as interest for both domestic and tax treaty purposes. This treatment could allow U.S. investors to inappropriately reduce their Canadian withholding tax liabilities once the withholding tax reduction in the fifth protocol to the Canada-U.S. tax treaty is fully in force. For example, a U.S. investor will have a preference for substituting non-deductible interest, which would not attract withholding tax, for a non-deductible dividend from its Canadian subsidiary (subject to withholding tax at five percent).

5.42 Some countries deem interest expense that is disallowed under their thin capitalization regimes to be treated as dividends subject to withholding tax. This treatment would be consistent with the policy underlying Canada's thin capitalization rules and would address the issue arising under the fifth protocol to the Canada-U.S. tax treaty. However, applying the same approach to disallowed interest paid to countries other than the United States, would have the effect of reducing the withholding tax collected in Canada on such payments.

5.43 The Panel encourages the government to review the treatment of interest expense not deductible under Canada's thin capitalization rules to ensure non-resident investors are prevented from inappropriately reducing their Canadian withholding tax obligations.

Back-to-back loans

5.44 The current thin capitalization rules prevent foreign businesses from circumventing the rules by financing their Canadian subsidiaries through an intermediate lender (i.e., by using "back-to-back" loans). The rule that addresses back-to-back loans is quite narrow. The Technical Committee on Business Taxation recommended strengthening this provision "to include all indebtedness (such as amounts on deposit) between a specified non-resident and a third party, where all or a portion of the amount may reasonably be considered to have been loaned or transferred, directly or indirectly, by the third party to a Canadian business."[90]

5.45 The Panel agrees with this recommendation and encourages the government to review the scope of the thin capitalization rule governing back-to-back loans, while ensuring that any changes in this area do not affect bona fide business transactions.

Specified non-resident shareholder

5.46 Canada's thin capitalization rules apply when a Canadian corporation borrows from a specified non-resident shareholder (or a non-resident person who is not dealing at arm's length with a specified shareholder). A specified non-resident shareholder of a Canadian corporation is a non-resident person who, alone or together with

90 Ibid.

non-arm's-length persons, owns shares of the corporation accounting for 25 percent or more of total votes or value of the corporation's capital stock. No issues were raised before the Panel in consultations regarding this definition. The Panel believes this threshold is appropriate and recommends that no change be made to the existing definition.

Debt dumping

As part of our mandate, the Panel was asked to review issues related to debt dumping with respect to foreign-controlled Canadian corporations.

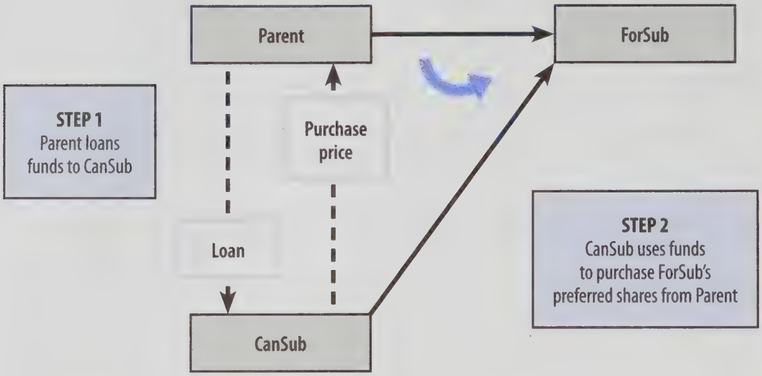
The term "debt dumping" has no precise definition. The term is typically considered to refer to situations where a foreign-controlled Canadian corporation is leveraged with related or third-party borrowings (the latter usually guaranteed by the corporation's non-resident parent company) so that the resulting interest expense significantly reduces the corporation's Canadian taxable income. The borrowings are often used by the foreign-controlled Canadian corporation to acquire shares in a related, non-resident company.

The Panel also heard that debt dumping could be used to describe situations where a Canadian corporation is acquired by a foreign or domestic company (usually a private equity fund or a domestic or foreign non-taxable entity) in a heavily leveraged buyout. In such transactions, the acquisition debt is typically absorbed by the acquired Canadian company and the related interest expense is used to significantly reduce or eliminate the taxable income of the acquired company. Therefore, some commentators described transactions that are exclusively domestic as debt dumping.

In summary, the term debt dumping can describe a variety of transactions, including many that are acceptable from a tax policy perspective. The Panel does not believe that all transactions involving foreign-controlled Canadian corporations that use related party borrowings or guaranteed debt to finance non-Canadian investments should raise tax policy issues. For example, as part of the normal expansion of its business, a foreign-controlled Canadian corporation might borrow to finance an investment outside Canada or to acquire a foreign company. Such outbound investment would be motivated by ordinary business considerations, would probably complement the company's Canadian operations, and would generate benefits for the Canadian economy. This result is similar for a Canadian corporation with foreign affiliates that is acquired by a foreign corporation and continues to borrow to finance its foreign operations.

Consistent with Recommendation 4.7, the Panel does not believe that interest expense should be restricted in situations where a Canadian company borrows to make a foreign investment with ordinary business motives. In the Panel's consultations, however, it was widely agreed that one particular type of debt-dumping transaction raises significant tax policy concerns.

Figure 5.2
Debt-dumping Transaction



5.52 The type of transaction in question involves a foreign-controlled Canadian corporation that borrows to acquire preferred shares of another related foreign corporation (see Figure 5.2 above).[91] In this circumstance, a foreign company ("Parent"), which owns all the common shares of a non-Canadian subsidiary ("ForSub"), loans funds to its Canadian subsidiary ("CanSub"). CanSub uses the borrowed funds to purchase preferred shares of ForSub, for example, from Parent. The arrangement is structured so that dividends received by CanSub on the preferred shares are exempt from tax in Canada. The dividend will be greater than the interest expense on CanSub's borrowing, which is deductible in Canada and reduces CanSub's Canadian tax liability on its profits derived from its Canadian operations.[92]

> "(Debt dumping) is problematic where the interest on the Canadian debt simply shelters Canadian income that would otherwise be subject to tax and does not lead to any economic benefits to Canada such as the creation of jobs in Canada or the expansion of Canadian business operations."
>
> *Submission of the Canadian Bankers Association, at p. 16.*

91 See in particular the submissions to the Panel of Deloitte & Touche LLP (at p. 11) and KPMG LLP (at pp. 5, 16, 18). See also the submissions of the Canadian Bankers Association (at p. 16) and the Canadian Chamber of Commerce (at p. 4) for additional discussion of debt dumping issues.

92 There are many variations of this basic structure. For example, CanSub could borrow funds from a Canadian or foreign third-party lender rather than directly from Parent. Under another alternative, CanSub could acquire newly issued shares of ForSub directly from ForSub rather than from Parent.

5.53 Where there is no other connection between the businesses conducted by CanSub and ForSub and especially where CanSub does not take part in the management of ForSub or share or benefit from an increase in the value of ForSub's operations subsequent to CanSub's investment, such a transaction has the effect of inappropriately reducing CanSub's Canadian tax liability. It permits Parent to leverage its existing Canadian operations by simply reorganizing the group's ownership structure. The reorganization may not have had any purpose other than to shift deductible expenses into Canada. As a result, the reorganization reduces the Canadian tax base, generates no new economic activity in Canada, and provides little or no economic benefit to Canadians. Any part of the return earned by CanSub that might be captured as Canadian taxes would typically be negligible (even more so if Parent is a U.S. company once the withholding tax on non-arm's-length interest paid to the United States is fully eliminated).

5.54 Preventing tax-motivated debt-dumping transactions would protect Canada's tax base and ensure that foreign-controlled Canadian corporations pay tax in Canada on their properly measured Canadian-source income. Reducing the maximum debt-to-equity ratio under the thin capitalization rules, as the Panel recommends, will not be enough to discourage such transactions. Canada needs to supplement its thin capitalization rules with a specific anti-avoidance rule addressing such transactions. The rule should be robust, easy to administer, and narrowly targeted to ensure it does not impede acceptable business transactions that benefit the Canadian economy.

RECOMMENDATION 5.3: *Curtail tax-motivated debt-dumping transactions within related corporate groups involving the acquisition, directly or indirectly, by a foreign-controlled Canadian company of an equity interest in a related foreign corporation while ensuring bona fide business transactions are not affected.*

5.55 Although the Panel believes that the type of debt dumping described above should be curtailed, distinguishing preferred shares from common shares is often difficult in practice. In the Panel's view, any proposed rule targeting these transactions should cover the acquisition of any equity interest in a non-Canadian affiliate by a foreign-controlled Canadian company.

5.56 In the Panel's consultations, Canadian businesses were nearly united in preferring a specific anti-avoidance rule to prevent abusive debt-dumping transactions over any broader reform of the thin capitalization rules. This approach is used in France and the Netherlands, which have similar anti-avoidance rules in place. Sweden is currently reviewing possible rules in this area.

5.57 The Panel identified two alternatives for specifically targeting these transactions:

- One approach would restrict the deductibility of interest paid by a foreign-controlled Canadian corporation in respect of borrowings used to purchase, directly or indirectly, an equity interest in a related foreign corporation.
- Another approach would apply an appropriate level of Canadian tax to the purchase price paid by the foreign-controlled Canadian corporation in respect of the direct or indirect acquisition of the equity interest in the related foreign corporation. For example, the purchase price paid by the Canadian corporation could be deemed to be a dividend subject to withholding tax in Canada.

5.58 Each option has its pros and cons. For example, the first option would be complex to implement, as it would require tracing of loans used to acquire foreign related companies. Such a rule may be easy for taxpayers to circumvent. Moreover, this option may also be inconsistent with non-discrimination clauses in some of Canada's tax treaties to the extent that any new restrictions on interest deductibility would apply to foreign-controlled corporations only and would be considered to deviate substantially from the restrictions currently in place.[93]

5.59 The second option is similar to an existing rule in Canada's tax law which has effectively curtailed certain related-party transactions which non-residents have used to leverage a foreign-controlled Canadian corporation.[94] The Panel believes that the rate of tax imposed on the value of the shares being acquired as part of debt-dumping transactions must be set high enough to discourage them. For example, if the purchase price is deemed to be a dividend subject to withholding tax, then the question would arise as to whether such deemed dividends should qualify for withholding tax relief under Canada's tax treaties. Such a deeming rule would lose its effect if the withholding tax rate were too low or if Canada were to eliminate its withholding tax on dividends under its treaties (see Chapter 6). An additional benefit of the second option is that no transitional or grandfathering rules would be needed to ensure existing structures are not affected.

5.60 The Panel believes that further study and consultation should be undertaken to assess the effectiveness of potential options for addressing the objectionable debt-dumping situations described above. The government should continue to monitor the financing of foreign-controlled Canadian corporations and take action if similar avoidance transactions arise in the future.

93 Under certain of Canada's tax treaties, Canada is prohibited from imposing restrictions on the deductibility of interest expense paid by foreign-controlled companies that are more stringent than restrictions otherwise applicable to Canadian corporations. The existing thin capitalization rules are specifically excluded from the scope of this non-discrimination clause provided the rules are not substantially modified.

94 Subsection 212.1(1) of the Act deems a dividend to be paid to a non-resident person by a non-arm's-length Canadian corporation where the Canadian corporation acquires from the non-resident person a non-portfolio interest in another Canadian corporation and the non-share consideration (e.g., cash or debt) for the acquired shares exceeds their paid-up capital.

Treaty shopping

Background

5.61 With 86 tax treaties in force,[95] Canada has one of the largest tax treaty networks among developed countries. Tax treaties offer benefits to investors, including lower withholding taxes on cross-border payments, reduced taxation of capital gains in the countries where the gains arise, and double tax relief in investors' home countries for taxes imposed abroad. Tax treaties also enable governments to exchange information, provide mutual assistance in tax collection, and encourage foreign investment.

5.62 If Canada's tax rules are to create a level playing field for domestic business activity carried on in Canada by foreign and Canadian businesses while ensuring Canadian-source income is properly measured and taxed in Canada, then Canada's treaty network has a critical role to play.

What is treaty shopping?

5.63 "Treaty shopping" refers to the practice of setting up structures through which a resident of one country (the "home country") derives income or capital gains from another country (the "source country") and obtains more generous tax treatment than would otherwise apply by accessing a tax treaty in place between the source country and a third country. Reducing treaty shopping may help to ensure the proper measurement and taxation of Canadian-source income. During our consultations, the Panel asked whether treaty shopping was a problem, and, if so, whether Canada needs additional tools to address it.

5.64 The Panel heard that businesses use treaties to mitigate the effect of delays in the negotiation or ratification of treaties when lower withholding rates are expected, to reduce the cost of capital on foreign investments, and to ease compliance burdens when treaty benefits are ultimately available. The Panel also heard that businesses select treaties to reduce tax on capital gains and real estate, to minimize income tax on active business income, and to move such income within a group with no or lower withholding taxes.

Canada's approach

5.65 Canada grants access to treaty benefits only to persons who are residents of a country with which Canada has entered into a treaty.[96] A corporation is a resident of a treaty partner if the corporation is liable to taxation in that country.[97] Certain treaty benefits, such as eligibility for reduced rates of withholding tax on dividends, interest and royalties, are limited to residents who are the "beneficial owners" of such income.

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95 As of December 1, 2008.

96 Canada Revenue Agency, *Income Tax Technical News No. 35* (February 26, 2007).

97 *Crown Forest v. Canada,* [1995] 2 S.C.R. 802, 95 D.T.C. 5389.

Neither Canada's tax treaties nor its domestic law define "beneficial owner". Courts in Canada and other countries have attempted to interpret or define what "beneficial owner" means,[98] and the Panel heard that it might be best to wait for a globally agreed definition before taking unilateral action in this regard. Moreover, the OECD Model Tax Convention on Income and on Capital and Commentaries set out numerous counter-measures, based on the concepts of residence and beneficial owner, which member states — including Canada — use in their treaties and domestic law to counter treaty shopping or limit access to treaty benefits.[99] The recent inclusion of a broad anti-treaty shopping provision in the fifth protocol to the Canada-U.S. tax treaty shows that Canada is willing to include such a provision in its tax treaties when it sees fit to do so.

In 2004, Canada extended application of its general anti-avoidance rule to tax treaties. However, a recent court case has cast doubt on the extent to which this rule could be used to counter treaty shopping.[100] A number of tax authorities, including the CRA, seem to be moving toward an implied general anti-abuse rule regarding improper tax treaty use.[101] A body of international jurisprudence is developing on what constitutes an abuse of a tax treaty (although these decisions have produced somewhat mixed results).[102]

Conclusion

The Panel believes that businesses should be able to organize their affairs to obtain access to treaty benefits. Tax treaties are complex and the relationships among tax treaties even more so. While there may be situations in which inappropriate access to tax treaties can arise, the Panel believes that Canada has adequate resources and tools in its tax treaties and domestic law and in international jurisprudence to police treaty shopping. However, the government should continue to monitor developments in this area.

98 *Prévost Car Inc. v. Canada*, 2008 D.T.C. 3080 (TCC); *Diebold Courtage*, Conseil d'État, October 13, 1999 (France); Royal Dutch, Hoge Raad, April 6, 1994, BNB 1994/217c (The Netherlands — the "market makers" case); and *Indofood International Finance Ltd. and JPMorgan Chase Bank NA, London Branch* (2006) EWCA Civ. 158 (Court of Appeal, Civil Division) which unlike *Prévost Car* and *Diebold Courtage* was not a tax case but a contract law case.

99 David A. Ward, *Access to Tax Treaty Benefits* (September 2008), research report prepared for the Advisory Panel on Canada's System of International Taxation, at section 2.

100 *MIL (Investments) S.A. v. Canada,* 2006 D.T.C. 3307 (TCC), affirmed 2007 D.T.C. 5437.

101 As discussed in "Treaty shopping and countermeasures, in particular the beneficial ownership concept", a presentation by Aurobindo Ponnaih, Head Asia-Pacific, International Bureau of Fiscal Documentation (July 3, 2007).

102 *Bank of Scotland*, Conseil d'État, December 29, 2006; *A Holdings ApS v. Federal Tax Administration*, (2005) 8 ITLR 536; *Yanko-Weiss Holding (1996) Ltd. v. Holon Assessing Office,* (2007) 10 ITLR 524. See also David A. Ward, op. cit.

6. Non-Resident Withholding Taxes

Canada's approach

6.1 Non-resident investors must pay a 25 percent Canadian tax on interest, dividends, royalties, rents and certain other payments derived from Canada. This tax is commonly referred to as a "withholding tax", because it must be withheld by Canadian residents making such payments to non-resident investors.

6.2 Canada's tax treaties provide for lower withholding tax rates, typically reducing the rate to 10 percent for interest and royalties and to five percent for dividends paid by a Canadian subsidiary to a foreign shareholder who holds a substantial interest in the Canadian subsidiary ("direct dividends"). Dividends derived from portfolio investments are taxed at a reduced rate of 15 percent.

6.3 Several exemptions from withholding tax are available under Canada's domestic law and tax treaties. A new exemption for interest paid to unrelated foreign creditors (arm's-length interest) took effect on January 1, 2008. Now when Canadian corporations owe amounts to unrelated foreign creditors, the creditors are no longer subject to Canadian withholding tax on interest.

6.4 Additionally, withholding tax on interest paid to related U.S. creditors (non-arm's-length interest) will be phased out over three years under the fifth protocol to the Canada-U.S. tax treaty. Once this change is fully implemented, no Canadian withholding tax will apply, for example, when a Canadian subsidiary pays interest on money borrowed from its U.S. parent corporation. Non-arm's-length interest paid to non-U.S. corporations will remain subject to withholding.

Evaluating the case for further reducing Canada's withholding taxes

6.5 In its 1998 report, the Technical Committee on Business Taxation expressed the following view:

> (T)he present Canadian position with respect to the level of withholding taxes under bilateral tax treaties is consistent with international norms, strikes an acceptable balance between the competing goals of global neutrality and protection of the Canadian revenue base, and, accordingly, requires no modification at the present time.[103]

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103 *Report of the Technical Committee on Business Taxation*, at p. 6.25.

6.6 Since 1998, significant developments have occurred that suggest revisiting this conclusion. First, since 1997, Canada has been a net capital exporter of foreign direct investment. Second, and perhaps more importantly, many countries have moved to reduce or eliminate withholding taxes. For example, EU countries have agreed to eliminate all withholding taxes on certain payments between associated EU companies.[104] The United States has also agreed with some of its trading partners — beginning with the United Kingdom in July 2001 — to eliminate withholding tax on direct dividends.[105] Australia has negotiated similar exemptions with the United Kingdom, France, Finland, Japan and Norway.

6.7 The Panel observed a consensus among companies and industry groups that Canada should adjust its policies to conform to these recent developments and eliminate withholding taxes. In particular, there were calls for Canada to renegotiate its tax treaties to eliminate the withholding tax on direct dividends.

6.8 The Panel believes that further reducing withholding taxes, especially on direct dividends, would benefit Canada economically. Eliminating withholding taxes between Canada and the United States, for example, would remove an obstacle to cross-border flows of income and capital and help Canadian businesses, including small businesses, to expand in the United States and potentially elsewhere. Eliminating withholding taxes on interest and dividends could also reduce the cost of foreign capital for Canadian businesses. Reducing withholding taxes on royalties could lower the cost of importing foreign technologies, helping to improve the productivity of Canadian businesses.

6.9 The magnitude of the potential economic benefits from eliminating withholding taxes needs to be fully assessed. Research commissioned by the Panel shows that eliminating withholding taxes on interest and dividends could greatly reduce the cost of investing in Canada for certain foreign firms.[106]

6.10 A portion of the withholding taxes collected in Canada on interest and direct dividends, which could potentially be significant, can be credited abroad.[107] To that extent, reducing withholding taxes in Canada may not attract significant additional investment to Canada; it would merely transfer tax revenues to foreign governments. The portion of withholding taxes credited abroad could rise further if the United States maintains its relatively high corporate income tax rate. However, this portion could drop if any

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104 Interest and royalties paid between associated EU companies are exempt from withholding tax following the entry into force of the Interest and Royalty Directive (2003/49/EC, June 3, 2003) in 2004. Dividends paid by EU subsidiaries to their EU parents have been exempt from withholding tax since 1992 under the Parent-Subsidiary Directive (90/435/EEC, July 23, 1990).

105 The following U.S. tax treaties now provide for a zero withholding tax rate on direct dividends (year signed or amended in parentheses): the United Kingdom (2001), Australia (2001), Mexico (2002), Japan (2003), the Netherlands (2004), Sweden (2005), Denmark (2006), Finland (2006), Germany (2006), and Belgium (2006). However, the revised U.S. Model Income Tax Convention released in late 2006 still provides for a five percent withholding tax on direct dividends.

106 Kenneth J. McKenzie, *An Analysis of the Economic Effects of Withholding Taxes on Cross-Border Income Flows for Canada* (September 2008), research report prepared for the Advisory Panel on Canada's System of International Taxation.

107 On average, about 75 percent of the tax collected by Canada on direct dividends was withheld on dividends paid to investors in the United States, the United Kingdom and Japan. Each of these countries provides a credit for foreign withholding taxes paid on foreign-source dividends, although the credit that can be claimed is generally subject to various types of limitations.

of the United States, the United Kingdom or Japan were to replace its foreign tax credit system with a territorial system for direct dividends because, as is the case for Canada, it is unlikely foreign withholding taxes on exempt dividends would then be creditable.

6.11 If withholding taxes were eliminated, foreign companies that could not credit them abroad might be encouraged to increase their investments in Canada. How much weight Canadian withholding taxes carry in the investment decisions of foreign companies is unknown. Empirical studies have suggested that lower corporate income taxes generate more inbound direct investment.[108] However, available studies on the impact of dividend withholding taxes found that they have little influence on how much capital companies will invest in a given country.[109] This finding may indicate that where dividend withholding taxes cannot be credited abroad, they act as cash-flow taxes rather than taxes on capital investment. Cash-flow taxes are not believed to affect the long-term investment decisions of international enterprises.[110]

6.12 The possible benefits of further reducing withholding taxes on royalties are also unknown. Canada has negotiated exemptions with its various treaty partners for royalties paid for the use in Canada of patents, know-how and software, which are the principal intangible assets used in industrial production.[111] Payments in respect of the use of intangible property that do not now qualify for a withholding tax exemption include trademarks and trade names, movies, cultural works (in certain circumstances), data and information, and unpatented knowledge other than know-how.

6.13 Canadian businesses may pay withholding tax on the interest, dividends and royalties they derive from investments in other countries. Reducing withholding taxes bilaterally could greatly benefit Canadian businesses to the extent their foreign withholding taxes paid are not currently creditable in Canada. The change would remove an impediment to repatriating foreign profits to Canada. Further, reduced foreign withholding taxes would produce a net income gain for Canada; the magnitude of this gain is unknown due to a lack of data on the amount of foreign withholding taxes paid by Canadian businesses.

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108 For a review of the existing literature, see Ruud A. de Mooij and Sjef Ederveen, "Taxation and Foreign Direct Investment — A Synthesis of Empirical Research", *International Tax and Public Finance*, vol. 10(6) (November 2003) at pp. 673-693. See also OECD, *Tax Effects on Foreign Direct Investment — Recent Evidence and Policy Analysis*, OECD Tax Policy Studies no. 17 (Paris: OECD, 2007), at pp. 45-66.

109 See Harry Grubert, "Taxes and the Division of Foreign Operating Income Among Royalties, Interest, Dividends and Retained Earnings", *Journal of Public Economics*, vol. 68(2) (May 1998), at pp. 269-290; Bruce A. Blonigen and Ronald B. Davies, "The Effects of Bilateral Tax Treaties on U.S. FDI Activity", *International Tax and Public Finance*, vol. 11(5), at pp. 614-615 (September 2004); and Ronald B. Davies, "Tax Treaties and Foreign Direct Investment: Potential versus Performance", *International Tax and Public Finance*, vol. 11(6) (November 2004), starting at p. 785.

110 See David G. Hartman, "Tax Policy and Foreign Direct Investment", *Journal of Public Economics*, vol. 26 (February 1985), at pp. 107-121. See also Parthasarathi Shome and Christian Schutte, "Cash-Flow Tax", *IMF Staff Papers*, vol. 40(3) (1993), at pp. 638-662.

111 Such exemptions were negotiated with Algeria (software and patent only), Australia (software only), Austria, Belgium, Denmark, Finland, France, Germany, Iceland, Ireland, Kyrgyzstan, Luxembourg, the Netherlands, Norway, Oman, Russia, Sweden, Switzerland, Ukraine (software only), the United Arab Emirates, the United Kingdom, and the United States.

Fiscal cost of reducing Canadian withholding taxes

6.14 The Panel acknowledges that eliminating withholding tax on direct dividends and interest and royalty payments that are not already exempt would come at a significant fiscal cost. In 2005, the government collected $4.3 billion in withholding taxes, half of which ($2.1 billion) was withheld on dividends paid to non-residents (see Table 6.1).

6.15 If withholding taxes were eliminated bilaterally, the net revenue cost would be lower because the government would no longer have to grant foreign tax credits in Canada for foreign withholding taxes paid by Canadian businesses. However, this offset is not expected to be significant. Foreign withholding taxes paid by Canadian corporations on exempt dividends from their foreign affiliates are not creditable in Canada, and receipts by Canadians of foreign-source interest and rents and royalties that are likely to be subject to foreign withholding tax are relatively small.[112]

6.16 The above discussion does not consider how eliminating withholding taxes could change taxpayer behaviour. Concerns arise that exempting all interest and royalty payments from withholding tax could put Canada's corporate income tax base at risk by increasing incentives for foreign businesses to pay out larger shares of their Canadian-source profits as deductible interest and royalties. Additionally, eliminating withholding taxes on direct dividends would provide an incentive for foreign-owned Canadian corporations to borrow in Canada to pay dividends to their foreign parents.

Table 6.1
Withholding Taxes Collected on Payments to Non-Residents 2000–2005 (millions of dollars)

	2000	2001	2002	2003	2004	2005
Direct dividends	713	739	790	690	778	1,362
Other dividends	448	467	468	501	678	739
Interest	492	617	514	549	676	717
Rents and royalties	562	615	676	730	733	730
Other payments*	295	324	390	411	378	734
Total	**2,510**	**2,762**	**2,838**	**2,881**	**3,242**	**4,283**

* *Includes withholding tax on social security benefits, pension income, and other types of income.*

Source: Canada Revenue Agency, NR4 Return. Totals may not add up due to rounding.

112 According to data from Statistics Canada, receipts of non-arm's-length interest payments from countries other than the United States were $650 million on average per year between 2000 and 2007. Average receipts of royalties for the use of trademarks, franchises and copyrights were $450 million between 2000 and 2006. An unidentified portion of such receipts would not be subject to foreign withholding taxes due to applicable exemptions. Source: Statistics Canada, CANSIM tables 376-0033 and 376-0062 and special request.

Withholding tax reductions versus lower corporate income tax rates

6.17 The government could reduce the immediate fiscal cost of eliminating withholding taxes by phasing them out over a number of years. Some of the lost tax revenues would be recouped through the greater economic activity in Canada generated by eliminating withholding taxes.

6.18 The same arguments can be made in favour of reducing other taxes. In the current fiscal framework, the government must assess which of the array of options to further reduce taxes would create the greatest economic benefit for Canadians per dollar of tax revenue foregone. The government must decide whether reducing withholding taxes is preferable to other beneficial tax reduction options, such as further reducing Canada's statutory corporate income tax rate.

6.19 During our consultations, the Panel posed this question directly, and most companies and organizations recommended lower corporate tax rates over lower withholding taxes. The reason for this preference may be that reducing the corporate tax rate would benefit all Canadian companies (including small and medium-sized businesses) and help improve the competitiveness of the Canadian economy more broadly. Another possible reason is that a large share of the withholding tax collected in Canada on payments to non-residents may be credited abroad and does not increase the tax burden of non-residents investing in Canada.

6.20 On balance, the Panel believes that further reducing withholding taxes is desirable for Canada. The Panel recommends that the government continue to reduce or eliminate withholding taxes in future tax treaties and protocols to those treaties. However, in recognition of the significant fiscal cost to the government and of the widely-shared preference among businesses for lower corporate income tax rates over lower withholding taxes, future reductions should be implemented as the government's fiscal framework permits, taking into account the government's currently planned reductions in the federal corporate tax rate. The government should also continue to monitor global trends and assess the desirability of eliminating withholding tax bilaterally on a case-by-case basis.

RECOMMENDATION 6.1: ***Consider further reducing withholding taxes bilaterally in future tax treaties and protocols to the extent permitted by the government's fiscal framework and its agenda regarding additional corporate tax rate reductions.***

7. Administration, Compliance and Legislative Process

Introduction

7.1 Several of the principles set out in Chapter 3 reflect a desire for greater simplicity and efficiency in Canada's administrative, compliance and legislative processes. The principle that Canada's international tax rules should be straightforward to understand, comply with, administer and enforce is obviously crucial in this regard. Open and timely consultation in advance of legislative change should help ensure new tax rules are well understood and operate as intended. Benchmarking our tax system's processes against those of other countries can help identify ways to make the tax system function more smoothly.

7.2 In Chapter 3, the Panel notes that having an effective self-assessment system requires a culture of mutual responsibility and cooperation. Throughout this report, the Panel recommends measures toward this goal. For example, our recommendations to simplify the current system should help reduce the potential for conflict between the CRA and businesses, while the recommendation and suggestions for targeted anti-avoidance rules aim to clarify for taxpayers and the CRA what types of planning should not be pursued.

7.3 In this chapter, the Panel sets out recommendations for simplifying the current system and easing the compliance burden of taxpayers and the administrative burden of the CRA in the following areas:

- mutual responsibility and cooperation,
- resources for administering the international tax system,
- transfer pricing administration,
- waivers from withholding tax obligations under regulations 102 and 105,
- taxable Canadian property,
- legislative process, and
- information management.

Enhancing mutual responsibility and cooperation

7.4 During our consultations, the Panel heard negative comments from various perspectives regarding the relationship between businesses and the CRA. These comments and the opposing positions behind them concern the Panel deeply. Further deterioration in the relationship could jeopardize the ongoing viability of Canada's self-assessment system, resulting in higher compliance and administration costs as well as more potential for dispute and litigation. Businesses, their advisors and the CRA all have a responsibility to ensure that our self-assessment system works effectively.

7.5 There are many positive instances of current government/taxpayer communication in the international taxation area. For example, the CRA and the Department of Finance often take part in presentations at private-sector conferences and provide comments on recent developments. Businesses told the Panel that they would benefit from more guidance from the CRA on international tax issues. The Panel believes these types of communication would assist both businesses and the CRA and should therefore be encouraged and expanded.

7.6 The Panel believes that a self-assessment system based on mutual responsibility and cooperation is critically important. More direct action is needed to reverse the current trend and improve the current relationship, and better two-way communication is the place to start. The government should take steps to begin this dialogue.

RECOMMENDATION 7.1: ***Take immediate action to enhance the dialogue among taxpayers, tax advisors and the Canada Revenue Agency to promote the mutual responsibility and cooperation required to uphold Canada's self-assessment system.***

7.7 In the Panel's view, improving communication and undertaking more consultation, as we recommend throughout this report, are important first steps toward a more robust self-assessment system. Achieving this goal should promote better compliance, facilitate enforcement, and reduce occasions for dispute.

Resources for administering the international tax system

7.8 Just as Canadian businesses face increasing complexity with the rise of international activities, the Panel recognizes that pressure on the CRA and the Department of Finance is also mounting, increasing their need for additional resources. The Tax Executives Institute told the Panel that the CRA needs more resources to:

- improve guidance for business taxpayers,
- better train CRA auditors and senior management in the global financial and business environment, and
- pay industry-competitive salaries and benefits to attract and retain tax professionals at all levels.[113]

7.9 The increase in international activities has spurred growth in the tax advisory community, making it more difficult for the CRA and the Department of Finance to compete for and retain appropriately skilled employees. For example, both the private sector and the CRA are devoting more resources to the recruitment of professionals who specialize in transfer pricing. Discrepancies between the public and private sectors in compensation levels for international tax specialists are compounding the CRA's challenges in retaining experienced employees.

7.10 Expanding the CRA's resources for improving communication and providing more clarity in areas where it is needed will help businesses, including small businesses, understand their obligations. Better compliance and fewer disputes should result. The government should consider further measures for improving communication and reducing the tax compliance burden related to the international expansion of small and medium-sized businesses.

7.11 The Panel's recommendations to simplify the existing system should help the CRA and the Department of Finance reduce administration requirements. For example, the possible elimination of the requirement for taxpayers to prepare surplus calculations should ease pressure on CRA resources. The proposals set out later in this chapter to simplify compliance obligations would also reduce or eliminate the CRA's administrative burden in these areas, allowing CRA professionals to reallocate their limited resources and focus their training on other areas, including transfer pricing. However, for Canada's system of international taxation to function smoothly and address the issues noted above, the Panel suggests the CRA and the Department of Finance allocate more resources to the international tax area. The Panel also thinks that interchange programs with the private sector should be considered.

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113 Submission of the Tax Executives Institute to the Advisory Panel on Canada's System of International Taxation, at p. 7.

Transfer pricing administration

Introduction

7.12 The Panel's review of Canada's transfer pricing regime focused on its administration. As discussed below, the Panel formed a subcommittee to provide comments and assistance with this review. In the course of our consultations, the Panel also heard about various substantive matters relating to the transfer pricing rules that could be considered to improve the system. However, given the Panel's primary focus on administration, this report addresses these substantive matters only briefly.

Canada's approach

7.13 "Transfer pricing" refers to the prices set for tax purposes of goods, services and intangibles transferred between related parties in cross-border transactions. The transfer pricing rules are intended to ensure that prices charged for goods, services and intangibles within the global corporate group reflect the same prices that would have been charged and paid if the transaction had involved unrelated parties or parties dealing at arm's length.

7.14 Canada's transfer pricing rules adhere to the "arm's length principle", which requires that transactions between persons not dealing at arm's length (i.e., related parties) reflect terms and conditions to which arm's-length persons (i.e., unrelated parties) would agree. All OECD member countries, including Canada, have adopted this approach.

7.15 In 1998, Canada adopted a new transfer pricing regime. These rules permit the CRA to adjust the quantum or nature of amounts to what would have been agreed to between arm's-length parties.[114] These new rules also added a compliance penalty, which focuses on the taxpayer's efforts in determining an arm's-length price. Unless the taxpayer has prepared, obtained and updated the required supporting documentation ("contemporaneous documentation"), the taxpayer may be subject to penalties for failing to make reasonable efforts to determine appropriate transfer prices.[115]

Process

7.16 In general, when the audit division of the CRA issues an income tax reassessment to which a taxpayer objects, the taxpayer files a Notice of Objection, which is reviewed by the CRA's Appeals group. If the taxpayer is not satisfied with the decision of the CRA's Appeals group, the taxpayer can file a Notice of Appeal with the Tax Court of Canada and proceed with litigation through the court system.

114 Subsection 247(2) of the Act.

115 Subsections 247(3) and (4) of the Act.

7.17 The process of resolving transfer pricing disputes is the same but may involve an extra step. The CRA's reassessment of a company's transfer prices may cause tax to be payable to more than one country on the same item of income, resulting in "double tax". For example, if the CRA reduces the cost of a good (bought by a taxpayer resident in Canada from a related party resident in another country) from $120 to $100, the ultimate profit of the Canadian resident when that good is sold in Canada would increase by $20, yet the related party would have paid income tax on that same $20 of income in the other country. This $20 of income has been taxed by both countries, and relief from double taxation is commonly obtained through tax treaties.

7.18 The Canadian competent authority is a group within the CRA having the authority to resolve double tax issues under Canada's tax treaties. In cases of potential double taxation, the taxpayer may ask the Canadian competent authority to negotiate the case with the officials from the other taxing jurisdiction,[116] a process which occurs under the mutual agreement procedure article of tax treaties.

7.19 A Canadian competent authority request is normally made after the taxpayer receives the reassessment. However, taxpayers must still file Notices of Objection and Appeal to retain their right to proceed to court later if they are not satisfied with the way the issue is ultimately resolved by the competent authorities. Normally, the CRA's Appeals group and the Court hold the matters in abeyance while the competent authority discussions proceed. In short, transfer pricing disputes are like most other tax disputes except there is an additional layer of dispute resolution involving the competent authorities of two states.

Transfer Pricing Subcommittee

7.20 The Transfer Pricing Subcommittee was formed with the mandate to identify and comment on issues commonly arising under the administration of the current transfer pricing provisions of the Act. The Subcommittee received input and comments from officials of the CRA and the Department of Finance regarding some of the issues that arose in the Subcommittee's review.

7.21 In its report,[117] the Subcommittee makes more than 20 recommendations to improve the process and administration of Canada's transfer pricing rules, with special emphasis on crafting solutions to current issues that will help both businesses and the CRA.

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116 In the area of transfer pricing, the Canadian competent authority is the Competent Authority Services Division within the International and Large Business Directorate of the CRA.

117 Transfer Pricing Subcommittee, *The Administration of Canada's Transfer Pricing Rules: Issues and Recommendations* (August 2008), report prepared for the Advisory Panel on Canada's System of International Taxation (herein referred to as "the Subcommittee Report").

7.22 The Panel recognizes that moving to a broader exemption system may exert more pressure on the application and administration of Canada's transfer pricing rules. If more transfer pricing disputes arise as a result, eliminating irritants arising from the current transfer pricing rules is important to ensuring the rules work as smoothly as possible. The Subcommittee believes that its recommendations target the major issues related to transfer pricing and that addressing them would enhance the application and administration of transfer pricing in Canada. In the Panel's view, the government should consider the recommendations in the Subcommittee Report as a basis for consultations in this area.

7.23 The Panel drew three main themes from the Subcommittee Report:

1. *Dispute resolution* — Resolving double taxation involves the interaction of two states and a process that is unique to international tax disputes. Rather than applying the general domestic rules and processes for resolving other tax disputes in the area of transfer pricing, adopting alternative processes may be more appropriate.
2. *Centralization and consistency* — Centralizing the expertise of CRA employees in the transfer pricing area and encouraging more knowledge-sharing among the CRA, businesses and advisors should foster mutual understanding and a more uniform approach to transfer pricing issues and audits for taxpayers and the CRA alike.
3. *Guidance and technical matters* — Offering more guidance on administration issues and resolving persistent technical issues could improve the application and administration of the transfer pricing rules by both the CRA and taxpayers.

Dispute resolution

7.24 The ways in which the domestic and competent authority processes interact can cause friction. Two recommendations of the Transfer Pricing Subcommittee regarding dispute resolution are as follows:

- When a taxpayer chooses to proceed to competent authority with a transfer pricing case, review of the Notice of Objection by the CRA's Appeals group and the appeal process at the Tax Court of Canada should be held in abeyance automatically.[118]
- Rules regarding tax prepayment or security and deficiency interest in transfer pricing cases should differ from the general rules applying to other tax cases because, in double taxation cases, tax has already been paid to another government in respect of that amount.[119]

118 Recommendation 5 of the Subcommittee Report.

119 Recommendations 7, 8 and 9 of the Subcommittee Report.

Centralization and consistency

7.25 Regarding centralization and consistency, two of the Subcommittee's recommendations are as follows:

- The CRA should increase its centralization of experience and expertise in transfer pricing matters within their headquarters in Ottawa. Giving CRA headquarters authority over transfer pricing issues would facilitate more consistent application of the transfer pricing rules throughout Canada.[120]
- The CRA should institute a program of exchanges and secondments between the private sector and CRA professionals. Such exchanges would benefit both sides by encouraging them to approach and analyze issues from the other's perspective.[121]

Guidance on technical matters

7.26 Examples of additional guidance and solutions to technical issues that could be provided include the following:

- The penalties imposed under Canada's transfer pricing regime do not apply where businesses make "reasonable efforts" to price their inter-company transactions appropriately. Additional guidance on what constitutes "reasonable efforts" for penalty purposes would be helpful.[122]
- Waivers allow taxpayers and the CRA to discuss and explore issues beyond the reassessment deadline otherwise set by the Act, allowing many issues to be agreeably resolved before a reassessment is issued. The current rules often restrict the use of waivers for transfer pricing issues because they cannot be obtained after four years from the date of the reassessment, even though CRA has seven years to reassess these issues. The period in which waivers may be granted should be changed to correspond with the reassessment period for transfer pricing.[123]
- Penalty thresholds could be raised so that small start-up businesses are not caught by penalties.[124]

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120 Recommendation 17 of the Subcommittee Report.

121 Recommendation 20 of the Subcommittee Report.

122 Recommendation 10 of the Subcommittee Report.

123 Recommendation 3 of the Subcommittee Report.

124 Recommendation 11 of the Subcommittee Report.

Conclusion

7.27 Applying and administering a transfer pricing regime requires special expertise in many areas, including international tax, economics and the relevant industry. Given this challenge, the Panel believes that making improvements in this area will require continuous attention and consultation. The Panel believes the Report of the Transfer Pricing Subcommittee is a solid starting point for consultations in this area.

RECOMMENDATION 7.2: *Take steps to improve administration of the transfer pricing rules in resolving disputes, centralizing knowledge for better consistency, and resolving technical issues.*

Safe harbours

7.28 The current transfer pricing rules require taxpayers to document all transactions with related parties, including charges for services provided by one related party to another. During our consultations, the Panel heard that businesses devote considerable time to documenting "routine, non-controversial cross-border service charges".[125] The United States has introduced temporary regulations that allow specific support services[126] to be reimbursed at cost.[127] These types of services usually would not involve a significant arm's-length mark-up on total service costs.[128]

7.29 Safe harbours for low-value services would ease the compliance and audit burden of businesses and the CRA and improve the administration of the transfer pricing process. The Panel encourages the government to consider their use.

Transfer pricing and intellectual property

7.30 Through our benchmarking research, the Panel learned that taxation authorities and businesses in other countries are struggling with the appropriate taxation of income from intangible property. In our consultations within Canada, the Panel asked whether any issues exist regarding the transfer pricing rules and how they apply to intellectual property created in Canada and sold to related parties abroad. While Canadian businesses noted that significant disagreements arise with taxation authorities regarding the pricing of intangibles, they indicated that the current transfer pricing rules (which fix the value of the intangible at the time of the transfer) are sufficient to address these issues.

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125 Submission of the Tax Executives Institute to the Advisory Panel on Canada's System of International Taxation, at p. 20.

126 For example, certain payroll services, accounts receivable services, and accounts payable services.

127 Treas. Reg. §1.482-9T(b).

128 Rev. Proc. 2007-13, 2007-3 I.R.B. 295, January 16, 2007.

7.31 As noted, the Panel's (and Subcommittee's) review targeted the administration of the transfer pricing rules, not their design. During our consultations, we heard that businesses often choose to move intellectual property out of Canada. This tendency concerns the Panel because moving to a broader exemption system as the Panel recommends will make the transfer pricing rules, especially as they apply to intellectual property, even more important to the protection of Canada's tax base.

7.32 Some other countries have adopted measures to deal with concerns about intangibles:

- The United States has adopted a "commensurate with income" approach, which ensures income paid for the transfer of an intangible corresponds to the income it generates.[129] This approach allows the U.S. tax authority to adjust income from sales of intangibles between related entities if it determines that payments were not at arm's length.
- Germany adopted a similar approach in 2008, with new rules to allow tax authorities to make a one-time transfer pricing adjustment within 10 years of a transaction where the actual profits generated by the intangible property differ substantially from the forecasts on which the original transfer price was based. The rationale for these rules is that if the pricing was subject to uncertainties when set, unrelated parties would agree to a periodic adjustment clause.[130]
- The United Kingdom had proposed to broaden the scope of income from intangible assets subject to tax under its equivalent of Canada's FAPI regime. This proposal did not involve a transfer pricing issue related to the transfer of intangibles. Rather, the UK tax authorities considered a regime that would have included as passive income "any active income to the extent that it is, in substance, passive income. (This would include any income to the extent that it derives from the ownership of — or rights over — intangible assets….)"[131] However, the United Kingdom appears to have abandoned this approach.[132]

7.33 The U.S. and German approaches of adjusting consideration based on subsequent information are controversial, and the UK proposal was criticized. While contentious, these approaches reflect rising international concern over the mobility of intangibles. The concerns are largely over fixing an appropriate price when an intangible is transferred outside a country's jurisdiction to tax. Determining arm's-length prices for intangibles is difficult for a variety of reasons, including a lack of comparable data for industry-specific intangibles and a lack of knowledge regarding future profitability.

129 The "commensurate with income" provision was added to Section 482 of the Internal Revenue Code in 1986.

130 Sec.1(3) sentences 11 and 12 of the Foreign Tax Act (AStG), as discussed in footnote 28 of Salim Damji and Ulrike Wolff, "German Business Tax Reform, Transfer Pricing Impacts", *Der Schweizer Treuhander* 2007/9, at pp. 684-688. Also see Richard Resch and Andreas Perdelwitz, "The German Tax Reform 2008 – Part 2", *European Taxation*, April 2008, at pp. 159-168.

131 HM Treasury and HM Revenue & Customs, *Taxation of companies foreign profits: discussion document* (June 2007), at para. 4.21.

132 HM Treasury, Open Letter and Technical Note (July 2008).

7.34 The Panel encourages the government to examine how the transfer pricing rules apply to transfers of intangibles to ensure the rules properly measure Canadian-source income. In accordance with the Panel's principles, this review should include consultation and regular research to benchmark Canada's international tax system against the tax systems of our major trading partners.

Waivers from withholding tax obligations under regulations 102 and 105

7.35 Sections 105 and 102 of the Income Tax Regulations impose withholding tax on payments for services rendered in Canada by non-residents. Regulation 105 covers situations where a fee is paid to a non-resident for services rendered in Canada while regulation 102 deals with compensation paid to an employee who is working in Canada.

7.36 Under regulation 105, payments to non-residents for services rendered in Canada are subject to withholding tax at a rate of 15 percent. The withholding is not the final tax; it is a prepayment on account of the non-resident's anticipated tax liability, which is determined when the non-resident's tax return is filed. After the filing, all or part of the amount withheld may be refunded, for example, if the non-resident qualifies for an exemption from Canadian income tax under a tax treaty or if the non-resident's total tax liability is less than the amount withheld.[133] If a foreign service provider can show, before performing the services in Canada, that the amount to be withheld is more than the ultimate Canadian income tax liability, the provider may apply for a waiver of the withholding tax under regulation 105.

7.37 Under regulation 102, non-resident employers have obligations similar to those of Canadian resident employers to withhold, remit and report amounts in respect of remuneration paid to an employee who renders services in Canada on behalf of the non-resident employer. Employers must remit withholding tax for each of their employees unless a waiver has been issued by the CRA. The withholding is not the final tax liability of the non-resident employee, who is required to file a Canadian income tax return to report the compensation or claim an exemption from Canadian tax under a tax treaty.

133 Under most treaties, business income earned by a non-resident in Canada is taxable in Canada only if the non-resident carries on the business through a permanent establishment in Canada.

Issues under the current rules

7.38 Concerns regarding regulation 105 were raised frequently during the Panel's consultations. Canadian businesses are frustrated by having to bear administrative responsibility for another person's tax liability. The Panel heard that:

- the costs associated with complying with regulation 105 are significant,
- service providers commonly gross-up their fees to offset the withholding tax, which can result in additional costs to Canadian businesses and hamper their ability to engage skilled workers from outside Canada,
- the waiver process is cumbersome and so it is not used as often as it should be, and
- the service provider may suffer reduced or delayed revenues and cash flow problems if the service provider has not received a gross-up from the payer.

> "In today's environment, business organizations staff their projects based on global skill sets .... Thus, access to skilled services and know-how is another key aspect of international competitiveness, especially where the skills or knowledge workers are not available in the Canadian market."
>
> — *Submission of the Tax Executives Institute, at p. 24.*

7.39 The Panel also heard that because regulation 102 applies to such a broad range of situations, it places a significant administrative burden on the non-residents, as well as Canadian corporations who carry out the administrative duties on behalf of related non-resident employers. For example, where a non-resident performs employment duties in Canada for just one day, a withholding obligation is placed on the employer. Although a waiver can be obtained if the employee ultimately will not be taxable in Canada, the time delay is often considerable, making the process unhelpful. In practice, it is difficult for non-resident companies to set up a process to withhold and remit various Canadian taxes for what may be small amounts.

The U.S. approach

7.40 The majority of Canada's trade is with the United States, yet Canada's withholding requirements regarding services and employment are much broader than the equivalent U.S. rules. While the United States requires withholding at the rate of 30 percent,[134] simplified procedures are in place to exempt amounts paid to a non-resident for services rendered in the United States if the recipient will be exempt from tax on that amount because of a tax treaty.

134 Section 1441 of the Internal Revenue Code requires 30 percent federal income tax withholding for independent personal services.

7.41 Under these procedures, the non-resident service provider files a form with the payer.[135] If the payer knows (or has reason to know) that any of the facts or statements on the form may be false or cannot be readily determined, then the payer must withhold. The non-resident is required to obtain either a U.S. social security number or individual taxpayer number and file a U.S. tax return.[136]

Conclusion

7.42 In the Panel's consultations, businesses indicated that the U.S. certification system for service providers (both employees and contractors) works well and is easier to comply with than the current Canadian system. The Panel foresees many potential benefits in adopting a similar certification system in Canada. Specifically:

- a certification system would shift the compliance burden at the withholding stage from the payer to the non-resident,
- Canadian payers would likely have to withhold less frequently, reducing administration for both businesses and the CRA,
- fewer withholdings would result in fewer gross-ups, producing cost savings for Canadian businesses,
- information reported on the non-resident's certificate and by the Canadian payer would maintain the CRA's ability to audit and enforce compliance, and
- the certification process would reduce the need to obtain waivers, eliminating administration for both businesses and the CRA.

RECOMMENDATION 7.3: *Eliminate withholding tax requirements related to services performed and employment functions carried on in Canada where the non-resident certifies the income is exempt from Canadian tax because of a tax treaty.*

7.43 See Appendix B for suggestions about how a Canadian certification system could be implemented in respect of withholdings under regulations 105 and 102.

7.44 Because the CRA would obtain the necessary information through the certification system to perform audits, there should be no significant impact on the tax due from non-resident service providers.

7.45 Moving from a system that requires either an advance waiver or withholding to a certification system may cause some decline in amounts collected. However, it would reduce the over-withholding of tax that can occur under the current system and the related costs to Canadian businesses.

135 See Form 8233, "Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual" and Form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding".

136 Returns need to be filed if the compensation income exceeds the personal exemption amount (currently $3,500).

Future considerations

7.46 Once fully in force, the fifth protocol to the Canada-U.S. tax treaty will increase pressure on the administration of regulations 105 and 102. The protocol increases the number of foreign service providers taxable in Canada because it broadens the definition of "permanent establishment".[137] The protocol also expands the circumstances in which Canada and the United States may tax each other's residents who exercise employment in the other contracting state.[138] While self-certification may reduce some of the current workload, other administrative changes may be needed to deal efficiently with non-resident service providers.

7.47 For non-resident service providers who will not qualify for an exemption from withholding based on the recommended certification system (for example, because they are not resident in a treaty country), the waiver process needs to be simplified, streamlined and better resourced by the CRA.

7.48 Simplified rules could be adopted for cases in which services are provided by related parties. Where the payer is a member of the corporate group, collection issues should be significantly reduced. Blanket waivers for services provided by parties related to Canadian businesses could be implemented. Annual reporting by Canadian businesses could function efficiently. Depending on the circumstances, security or guarantees could be required to ensure amounts waived could be collected if they are owed.

7.49 The CRA should consult with business groups about how the current reporting requirements could be streamlined to ease the compliance and administrative burden on taxpayers and the CRA.

Taxable Canadian property

Current rules

7.50 "Taxable Canadian property" is a class of property that Canada considers to derive its value from sources in Canada. A non-resident is taxable in Canada on gains from sales of such property unless the non-resident is eligible for benefits under one of Canada's tax treaties. On selling certain taxable Canadian property, the non-resident must notify the CRA and the purchaser must withhold 25 percent of the proceeds, unless the non-resident presents a certificate of compliance (commonly known as a "section 116 certificate") to prove that the purchaser's withholding and remittance obligations are reduced or eliminated.

137 The fifth protocol to the Canada-U.S. tax treaty added a special rule for services to Article V, paragraph 9 of the treaty.

138 Article X of the fifth protocol.

Issues under the current rules

7.51 Many foreign businesses with interests in taxable Canadian property are eligible for treaty benefits and so they view the section 116 certificate process as a costly nuisance that can cause delays. To obtain a section 116 certificate, the non-resident must file with the CRA one or more applications supported by numerous documents. Unless the purchaser has obtained either a section 116 certificate or a letter from the CRA that administratively relieves the purchaser of its withholding obligations, the purchaser must remit any amounts withheld. Because the CRA currently faces a backlog in processing section 116 certificates, it regularly provides letters to non-residents to facilitate trade settlement, closings, escrow or security arrangements, and other transactions. The non-resident also must file a Canadian tax return (with the section 116 certificate attached) to finalize a claim for treaty benefits or to obtain a refund of amounts remitted to the CRA.

Recent relief

7.52 Recent changes will streamline the section 116 certificate process starting in 2009. Recognizing that most tax treaties allow Canada to tax capital gains only on Canadian real property and resource and timber properties (and shares of companies that derive most of their value from such properties), there is no longer a need to withhold tax on dispositions of other property that Canada will not ultimately tax ("treaty-protected property"). Non-residents who dispose of treaty-protected property no longer have to obtain a section 116 certificate or file a Canadian tax return as long as they do not owe Canadian tax for other reasons.

7.53 The recent measures are expected to improve the section 116 certification process. Canadian and non-resident businesses welcome the reduced tax compliance burden.

More relief required

7.54 During the Panel's consultations, however, businesses called for more changes. They told the Panel that the measures do not go far enough to provide purchasers of taxable Canadian property with certainty about their withholding and remittance obligations. Further, the changes offer no relief to members of partnerships and other non-corporate entities that are eligible for treaty benefits on a look-through basis. This may negatively affect Canada's ability to access foreign capital, particularly by private companies.

7.55 Additionally, some non-resident investors or their financial intermediaries must still obtain section 116 certificates when they sell certain Canadian securities (such as units of some business income trusts or limited partnerships). The Panel considered whether the sale of such securities should be excluded from the section 116 process without the need to determine if gains on such securities are treaty-protected. Currently, only shares listed on certain exchanges and mutual fund trust units are so excluded. In the Panel's view, the exclusion should cover the full range of publicly traded Canadian securities.

7.56 To simplify and reduce the compliance burden for purchasers of taxable Canadian property, the Panel has concluded that the section 116 certificate process should be simplified by adopting a treaty benefit certification process and by excluding all publicly traded Canadian securities from the section 116 certificate process.

RECOMMENDATION 7.4: *Eliminate withholding tax requirements related to the disposition of taxable Canadian property where the non-resident certifies that the gain is exempt from Canadian tax because of a tax treaty.*

RECOMMENDATION 7.5: *Exclude the sale of all publicly traded Canadian securities from notification and withholding requirements under section 116 of the Income Tax Act.*

Legislative process

7.57 The development and adoption of new tax legislation in Canada is a complex process that involves many concerned parties. Divergent groups take part in the tax policy debate in Canada, including political and business organizations, unions, policy institutes, public interest groups, and individuals.

7.58 In developing its tax policy agenda, the government seeks input from these groups and the general public through many channels. The House of Commons Standing Committee on Finance conducts pre-budget consultations and releases a pre-budget report that makes tax policy recommendations to the government. The Minister of Finance also conducts pre-budget consultations to obtain input from Canadians directly. Consultations on particular issues — such as those conducted by the Panel — also occur periodically.

7.59 Once the government decides on a tax policy, the Tax Policy Branch of the Department of Finance drafts the tax legislation to implement it. Most of the time, proposed tax legislation is released in draft form to solicit comments and suggestions from interested parties. Draft tax proposals are announced as part of the annual federal budget and throughout the year by news release. Once the government is satisfied with the changes put forward, the proposed legislation is tabled in a bill in Parliament, where it undergoes the normal parliamentary review process. The bill is enacted into law when it receives royal assent.

7.60 Certain features of the legislative process in Canada make it more open and accessible to taxpayers than the processes in other developed countries, notably the United States. For example, the Department of Finance often accommodates taxpayers by issuing "comfort letters" that confirm the Department's intention to recommend changes to fix technical flaws in the tax law. This practice, which has been a feature of Canada's legislative process for more than 20 years, is one example of how the current process can address taxpayers' needs.

7.61 There is scope, however, for improving other aspects of the process. The existing process gives Canadians opportunities to raise their concerns with the government at different stages. The Panel heard calls for the government to consult more extensively before policy decisions are reached. This issue arises in other countries, such as Australia, which has undertaken a detailed review of its legislative process.

7.62 Open and timely consultation is one of the principles set out by the Panel in Chapter 3. Allowing businesses and their advisers to raise their concerns at the policy design stage would reduce the risk that a new rule would produce unintended and adverse results, making the process more efficient. Consultations at an early stage could also increase the transparency of the legislative process. Transparency is crucial to sustaining a fair and open process for making tax policy in Canada.

> "The Government (of Australia) should generally consult on tax changes at the initial policy design stage, prior to any Government announcement. For major policy changes, consultation should include public consultation on policy design (e.g., via the release of a discussion paper) ...."
>
> — *Government of Australia,* Better Tax Design and Implementation: A Report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs *(April 30, 2008), at p 4.*

7.63 The Panel encourages the government to make every effort to achieve more transparency. The government should resort to confidentiality only where necessary, for example, where proposed tax policy changes could affect financial markets or commodity prices or where these changes could have a material revenue impact. The government should also provide better public access to information and analysis supporting proposed tax policy changes, such as by publicizing revenue impact estimates.

7.64 The Panel also observed a strong consensus that retrospective legislation should be avoided. Proposed legislation that remains outstanding for a long time period and has a coming-into-force date that precedes its date of adoption can also be problematic, especially for companies that must prepare their financial statements in accordance with "substantively enacted" legislation. Australia's Tax Design Review Panel (cited above) recommended that most new tax measures should be prospective and introduced in Parliament within 12 months of their announcement, with all retrospective measures introduced within six months of announcement. The Panel agrees that the Canadian government should avoid introducing tax legislation with retroactive application.

Information management

7.65 The CRA and the Department of Finance need access to information about taxpayers and their cross-border transactions. The CRA needs information to administer Canada's system of international taxation, assess compliance risk, and better target its enforcement efforts. The Department of Finance needs information to assess properly the current system and evaluate new policy initiatives so that all relevant information and analysis is considered when making tax policy decisions.

7.66 The CRA collects much of the information the government requires directly from taxpayers. To be useful, this information must be relevant, reliable and timely. The government also needs adequate information management systems for processing and analyzing this data efficiently.

7.67 In conducting our work, the Panel had difficulty obtaining certain data needed to evaluate the current international tax system and assess other options. These problems are due in part to the quality of the data collected and in part to the lack of any requirement for taxpayers to provide certain information. More importantly, the information management systems in place to store and analyze data from taxpayers do not seem to have the same functionality as the systems typically in place in the private sector.

7.68 Other governments face similar challenges in collecting and managing taxpayer information.[139] While the CRA and the Department of Finance have made considerable efforts to improve the situation, more can be done to enhance the government's ability to properly assess the impact of proposed tax changes and anticipate possible behavioural responses.

139 See, for example, U.S. Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (November 2007) at pp. 26 and 28.

7.69 The Panel believes that the government should take steps to streamline and optimize its approach to the collection and use of taxpayer information in the international tax area. Existing information management systems should be improved to allow for more efficient use of the data currently collected. The CRA and the Department of Finance should also collaborate and undertake consultations toward developing a comprehensive, long-term plan to optimize the way taxpayer information is collected and used. This plan should specify:

- what and how much information is required, and for what purposes,
- how, when and from whom the information should be collected,
- how the information should be captured, stored, maintained, validated and distributed, and
- what systems are needed to analyze and make the best use of the information.

RECOMMENDATION 7.6: *Develop a comprehensive, long-term plan to optimize tax information collection, and set up the information management systems needed to efficiently process and analyze this information.*

7.70 As a first step, the Panel has undertaken a preliminary review of options to improve some of the forms and returns used to gather information on cross-border transactions. Input from business and the government was obtained through an ad hoc subcommittee composed of Marvin E. Lamb, CMA, and Monika M. Siegmund, CA, of the Tax Executives Institute and France Marengère of the CRA. The Panel would like to thank the members of the subcommittee as well as the individuals who participated in their consultations.

8. Looking Ahead

Introduction

8.1 In this report, the Panel sets out our views on the current state of Canada's system of international taxation and offers an integrated package of recommendations for improving it.

8.2 In the course of the Panel's work, other important tax policy choices became apparent that may influence the competitiveness of Canadian businesses and of the Canadian economy in the future. Consistent with the principle that Canada's system of international taxation should be benchmarked regularly against the systems of our major trading partners, this chapter highlights issues that the government should monitor as international tax norms evolve. These issues are source-based taxation, neutrality among substitutable economic returns, and tax consolidation.

Source-based taxation

8.3 Tax systems require "source" rules to determine where income is earned. These rules emerge from legislation, jurisprudence and tax treaties, and they consider both the place from which income arises and the activities that generate it. Income from a business is usually earned where "the operations take place from which the profits in substance arise".[140]

8.4 Canada's source rules — like those of other countries — face challenges due to globalization facilitated by electronic commerce and the increased mobility of capital and labour.

8.5 When business operations require physically fixed establishments to carry on, there is little doubt about the place from which profits arise. Electronic commerce does not require physically fixed structures for its operations: all it may need, for example, are information technology support, call centres, server farms, telecommunications infrastructure, goods, services or intangible products, and a market — all of which could be located anywhere. Thus, it is difficult to pinpoint from where "profits in substance arise".

140 *FL Smidth and Company v. F Greenwood*, (Surveyor of Taxes), [1921] 3 K.B. 583 at p. 593, quoted in *Gurd's Products Co. v. R.*, 1985 CarswellNat 310.

8.6 In addition, income from services is usually earned where the services are provided. Since services are mobile, there is a risk that income from services can be diverted for tax reasons from one place to another. Income from financial instruments is generally said to arise where the issuer of the underlying debt or security resides. However, because the issuer has flexibility in where it locates, there may be little economic connection between the location of the issuer and the economic benefits of the financing.

8.7 A consequence of these challenges is that the source rules are increasingly difficult to apply and are open to planning. Monitoring developments in this area is important to ensure Canada remains in step with international tax norms.

Neutrality among substitutable economic returns

Other returns from foreign affiliates

8.8 For many years, Canada's international tax policy has been to exempt foreign active business income earned by a foreign affiliate where certain conditions were met. In practice, Canada's international tax system has partly reflected that shareholders are often indifferent as to whether they receive their returns from their outbound business investments as dividends, interest, rents or royalties.

8.9 A Canadian shareholder can capitalize its foreign affiliates with either debt or equity, or rent or license property (tangible or intangible) to the affiliates. The tax effects of using equity, debt or other capital investments are quite different: interest, rents and royalties received by a shareholder are subject to full Canadian tax, whereas most dividends from foreign active business income are exempt from Canadian tax.

8.10 Equity, debt and other capital investments held by a Canadian shareholder in a foreign affiliate are often substitutable. Therefore, absent tax considerations, it could make no difference to a shareholder whether its returns are received in the form of dividends, interest, royalties or any combination of such income.

8.11 Arguably, an integrated tax policy should treat all foreign-source active business income similarly. If Canada's international tax policy were to exempt foreign active business income earned by a foreign affiliate from Canadian tax, the policy should perhaps also apply regardless of whether the return received by the Canadian shareholder were to take the form of dividends, interest, rents or royalties.

8.12 This view may appear counter-intuitive as interest, rents and royalties paid by a foreign affiliate are usually deductible (reducing foreign taxable income) while dividends are not. However, whether a payment is deductible in a foreign country should not necessarily influence the Canadian tax treatment of that amount. For example, if foreign thin capitalization rules operate to deny an interest deduction abroad, the denial does not affect the Canadian tax treatment of the amount.

8.13 In addition, Canada's international tax policy allows Canadian businesses the flexibility to structure their affairs to reduce their total foreign tax cost on interest and royalties by creating foreign financing, leasing and licensing companies.

8.14 While this policy allows Canadian businesses to reduce foreign tax costs without reducing Canadian tax otherwise payable, it encourages Canadian companies to establish complicated structures in other countries, incurring the costs and administrative burden of setting up and maintaining companies or branches, hiring and managing employees, and engaging and paying professional advisors.

8.15 Accordingly, rather than carrying out financing, leasing or licensing functions in a foreign jurisdiction, consideration could be given to encouraging Canadian companies to carry out these functions in Canada, along with any related research and development. Potential benefits of this approach include:

- increased investment in research and development activity in Canada by both Canadian and foreign multinational corporations,
- increased repatriation of intellectual property to Canada for further development and licensing, and
- increased commercialization of intellectual property in Canada.

8.16 These results might be achieved by exempting this income from Canadian tax or taxing it at a preferential rate, as is done (or is being considered) by certain countries.[141]

Allowance for corporate equity

8.17 Nearly all countries that tax corporate income allow a deduction for interest paid on debt, but not for dividends paid to shareholders. This asymmetric tax treatment is often seen as creating a bias in favour of debt financing over equity financing, creating the need for rules to limit the deductibility of interest paid by foreign-owned businesses.

8.18 Many options could be considered by the government to ensure a more neutral tax treatment between debt and equity financing. One option would be to allow corporations to deduct an imputed cost for their corporate equity by claiming an allowance for corporate equity (ACE) when computing their income for tax purposes. Two countries, Belgium and Brazil, currently have some form of an ACE system, while Austria, Croatia and Italy have experimented with this approach.

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141 See discussion in OECD, *Tax Effects on Foreign Direct Investment — Recent Evidence and Policy Analysis*, OECD Tax Policy Studies no. 17, 2007, at pp. 15, 21-22, 104-106 and 116. See also Department of Treasury, Office of Tax Policy, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (December 2007) at p. 62 and the discussion of planning used to reduce U.S. taxes on foreign royalties at pp. 45-46.

An ACE system could reduce the need for thin capitalization rules and other forms of interest deductibility limitations by enhancing neutrality between debt and equity financing. Such a system could also reduce existing distortions on real investment caused by the taxation of capital income at the corporate level. However, implementing an ACE system might require increasing the statutory corporate tax rate to make up for any revenue shortfall, which could, among other drawbacks, cause highly profitable firms to relocate abroad.

Tax consolidation

In the Canadian tax system, each corporation is taxed as a separate entity. Unlike most other developed countries, Canada does not permit consolidation for tax purposes nor does it have explicit rules to permit corporations to transfer losses within a group. Rather, all members of the same corporate group compute their tax liabilities and file their tax returns separately.

The Canadian government previously considered the advantages of group reporting systems including consolidation.[142] However, tax consolidation raises provincial tax issues involving income and loss allocation and their effect on provincial government revenues.

Given the prevalence of consolidation in other countries, the federal and provincial governments should work together to consider how a tax consolidation system could operate in Canada.

142 Department of Finance Canada, "A Corporate Loss Transfer System for Canada", Discussion Paper (Ottawa: Department of Finance Canada, May 1985).

Appendix A List of Recommendations

Taxation of outbound direct investment

Recommendation 4.1: Broaden the existing exemption system to cover all foreign active business income earned by foreign affiliates.

Recommendation 4.2: Pursue tax information exchange agreements (TIEA) on a government-to-government basis without resort to accrual taxation for foreign active business income if a TIEA is not obtained.

Recommendation 4.3: Extend the exemption system to capital gains and losses realized on the disposition of shares of a foreign affiliate where the shares derive all or substantially all of their value from active business assets.

Recommendation 4.4: Review the "foreign affiliate" definition, taking into account the Panel's other recommendations on outbound taxation, the approaches of other countries, and the impact of any changes on existing investments.

Recommendation 4.5: In light of the Panel's recommendations on outbound taxation, review and undertake consultation on how to reduce overlap and complexity in the anti-deferral regimes while ensuring all foreign passive income is taxed in Canada on a current basis.

Recommendation 4.6: Review the scope of the base erosion and investment business rules to ensure they are properly targeted and do not impede bona fide business transactions and the competitiveness of Canadian businesses.

Recommendation 4.7: Impose no additional rules to restrict the deductibility of interest expense of Canadian companies where the borrowed funds are used to invest in foreign affiliates and section 18.2 of the Income Tax Act should be repealed.

Taxation of inbound direct investment

Recommendation 5.1: Retain the current thin capitalization system, and reduce the maximum debt-to-equity ratio under the current thin capitalization rules from 2:1 to 1.5:1.

Recommendation 5.2: Extend the scope of the thin capitalization rules to partnerships, trusts and Canadian branches of non-resident corporations.

Recommendation 5.3: Curtail tax-motivated debt-dumping transactions within related corporate groups involving the acquisition, directly or indirectly, by a foreign-controlled Canadian company of an equity interest in a related foreign corporation while ensuring bona fide business transactions are not affected.

Non-resident withholding taxes

Recommendation 6.1: Consider further reducing withholding taxes bilaterally in future tax treaties and protocols to the extent permitted by the government's fiscal framework and its agenda regarding additional corporate tax rate reductions.

Administration, compliance and legislative process

Recommendation 7.1: Take immediate action to enhance the dialogue among taxpayers, tax advisors and the Canada Revenue Agency to promote the mutual responsibility and cooperation required to uphold Canada's self-assessment system.

Recommendation 7.2: Take steps to improve administration of the transfer pricing rules in resolving disputes, centralizing knowledge for better consistency, and resolving technical issues.

Recommendation 7.3: Eliminate withholding tax requirements related to services performed and employment functions carried on in Canada where the non-resident certifies the income is exempt from Canadian tax because of a tax treaty.

Recommendation 7.4: Eliminate withholding tax requirements related to the disposition of taxable Canadian property where the non-resident certifies that the gain is exempt from Canadian tax because of a tax treaty.

Recommendation 7.5: Exclude the sale of all publicly traded Canadian securities from notification and withholding requirements under section 116 of the Income Tax Act.

Recommendation 7.6: Develop a comprehensive, long-term plan to optimize tax information collection, and set up the information management systems needed to efficiently process and analyze this information.

Appendix B Technical Issues for Further Study

B.1 In this Appendix, we discuss technical issues arising from or related to the recommendations in the body of this report. We also point out some potential solutions to these issues that the government may wish to consider.

Taxation of outbound direct investment

Draft foreign affiliate technical amendments

B.2 The Department of Finance has proposed amendments to prevent taxpayers from creating exempt surplus inappropriately in certain types of inter-affiliate transactions and to consolidate surplus balances of foreign affiliates within a particular group. These proposals were first released on December 20, 2002, and revised proposals were released on February 27, 2004.

B.3 These proposals will add significant complexity to the current exempt and taxable surplus computations, increasing the compliance and administrative burden for taxpayers and the CRA. The Panel agrees with comments in submissions we received that these proposals are an "extreme reaction"[143] to situations where only a relatively modest amount of tax is at stake.

B.4 Given the Panel's recommendations to broaden the exemption system for active business income and to exempt capital gains and losses arising on the sale of shares of foreign affiliates that are excluded property, these particular proposed amendments should be abandoned, as there would be no need to compute surplus balances. The other foreign affiliate proposals released on February 27, 2004 and subsequently by the Department of Finance should be reviewed in light of the Panel's recommendations.

Capital gains on sales of foreign affiliate shares: Additional considerations

B.5 This section elaborates on some issues and possible alternatives the government should consider in extending an exemption to capital gains on the sale of shares of foreign affiliates.

143 Submission of Deloitte & Touche LLP to the Advisory Panel on Canada's System of International Taxation, at p. 4.

Excluded and non-excluded property

B.6 The current "excluded property" definition includes a point-in-time test. Under a broader exemption system that exempts capital gains on the sale of shares of a foreign affiliate that are excluded property, businesses will want to ensure that such dispositions qualify for the exemption at that point in time. Anti-avoidance rules may be needed to prevent transactions designed to qualify foreign affiliate shares as excluded property in inappropriate circumstances.

B.7 For example, a foreign affiliate could purchase active business assets immediately before a sale that are unrelated to its active business for the principal purpose of qualifying the foreign affiliate's shares as excluded property and thus eligible for the exemption. The purchased assets would not represent a bona fide investment by the taxpayer in an active business because they would not have been acquired primarily for business reasons. The Panel believes such transactions are inappropriate and should be subject to an anti-avoidance rule.

B.8 A different set of transactions could involve a company disposing or otherwise removing non-excluded property assets from a foreign affiliate that is being disposed of so that its shares would be considered excluded property at the time of sale. Unlike the transactions described above, this planning seems appropriate and should not be subject to an anti-avoidance rule.

Holding period

B.9 The current rules impose no holding period requirements in assessing whether shares of a foreign affiliate qualify as excluded property. In a broader exemption system, a minimum holding period may be considered appropriate to ensure the exemption does not extend to situations where the investment in the foreign affiliate is merely a temporary passive one. This approach could also appropriately restrict the exemption where additional shares are acquired immediately before a sale for the principal reason of qualifying the foreign corporation as a foreign affiliate. However, as noted in paragraph B.8, the Panel believes it should not be necessary for the shares to derive all or substantially all of their value from active business assets throughout the holding period.

Dividend stripping

B.10 If the exemption system is broadened to cover dispositions of foreign affiliate shares, additional changes may be required to address the inappropriate reduction of a capital gain arising on the sale of shares of either a Canadian corporation or a foreign affiliate.

B.11 In practice, the link between retained earnings (referred to as "safe income"), dividends and capital gains is important because safe income can reduce a capital gain otherwise arising on a sale of the corporation's shares. This reduction can occur where a Canadian corporation disposes of the shares of another Canadian corporation and, under the current rules, where there is a disposition of the shares of a foreign affiliate.

B.12 The tax policy rationale for this treatment is that the portion of the capital gain that is derived from a corporation's safe income should not attract capital gains tax as this amount has already been subject to corporate income tax. In other words, only the portion of the capital gain that represents capital appreciation unrelated to retained earnings should attract capital gains tax. Under the current rules, the surplus accounts form the basis for determining the safe income of a foreign affiliate.

B.13 In a system that exempts the capital gain on the disposition of shares of a foreign affiliate but taxes capital gains from the disposition of shares of a Canadian corporation that has an interest in a foreign affiliate, the computation of safe income of a foreign affiliate should be considered. There may be an inclination to retain the current surplus computation rules for this purpose. However, there may be simpler alternatives. For example, consideration could be given to increasing the safe income of the Canadian corporation by an appropriate amount representing the accrued gain attributable to foreign affiliate shares that are excluded property and previous dividends from these foreign affiliates.

B.14 If safe income of a foreign affiliate were to continue to be measured, simpler ways of measuring it should be considered, for example, by referring to financial statements of the foreign affiliate. The limitations of using financial statements should be weighed against the benefits of eliminating the need for businesses to perform additional complex calculations that in many circumstances may not provide a number that is substantially different from, or more accurate than, the financial statement amounts.

B.15 Additional changes should probably be considered independent of the choices made regarding the computation of safe income of a foreign affiliate. For example, the current anti-avoidance rule to address dividends paid on the shares of a Canadian corporation in excess of safe income could be extended to cover dividends paid from foreign affiliates. The rule may have to be tailored to operate differently depending on whether the foreign affiliate shares are excluded property.

B.16 For example, where the shares are not excluded property, an anti-avoidance rule could apply where dividends on the foreign affiliate shares inappropriately reduce a capital gain on those foreign affiliate shares. However, where the foreign affiliate shares are excluded property (and so any gain on those shares would be eligible for an exemption), the matter is more complicated. Depending on which system the government chooses for computing the safe income of a foreign affiliate, additional guidance may be required to ensure that dividends from foreign affiliates do not inappropriately increase the safe income of an upstream Canadian shareholder.

Foreign affiliate reorganizations: Eliminating potential FAPI

B.17 The current and proposed rules involving foreign affiliate reorganizations are extremely complicated. In certain circumstances under these rules, foreign affiliate reorganizations that do not change the overall economic ownership of the affected affiliates can still result in FAPI.

B.18 In many circumstances, a reorganization can be undertaken or carried out in a specific way for foreign tax or foreign corporate law reasons. The Panel believes that, in principle, FAPI should not be realized in reorganizations where the overall economic ownership of the affected affiliate and its assets remains the same.

B.19 The Panel expects that our recommendations to move to a broader exemption system for active business income and to exempt gains and losses arising on the sale of shares of foreign affiliates that are excluded property will simplify the current provisions dealing with reorganizations of foreign affiliates. The Panel recommends amending these rules to ensure FAPI does not arise in reorganizations where the overall economic ownership of the affected affiliate and its assets does not change.

Transitional rules: Taxable surplus

B.20 Under a broader exemption system, companies would no longer need to track exempt or taxable surplus of their foreign affiliates. Dividends would be exempt from taxation, as would gains from the disposition of foreign affiliate shares that are excluded property.

B.21 A question arises as to treatment of existing exempt and taxable surplus balances at the time of the change to a broader exemption system. A number of options could be considered, including a complete amnesty or a moderate toll charge for the repatriation of taxable surplus. Other options tend to be complicated and could create further tax policy issues.

B.22 Because the current system generates little tax revenue from dividends paid out of taxable surplus, the Panel would support a complete amnesty from Canadian tax for amounts accumulated in the taxable surplus balances of those affiliates whose shares will qualify as excluded property under the recommended broader exemption system. Special consideration may need to be given to foreign affiliates whose shares are not excluded property.

Changes to the "excluded property" definition: Additional considerations

B.23 A foreign affiliate's "excluded property" includes its property used or held principally to earn active business income and its shares of another foreign affiliate where all or substantially all of the fair market value of the other affiliate's property is attributable to excluded property of that affiliate.

B.24 The Panel recommends that capital gains arising on the sale of shares of a foreign affiliate be exempt if the shares are excluded property. To maintain the integrity of a broader exemption system, the definition of "excluded property" should be robust enough to ensure shares are appropriately classified as excluded property or not. In Chapter 4, we discuss certain changes to the "excluded property" definition that would need to be considered. We now identify other considerations.

Multiplier effect

B.25 In determining the status of the shares of a higher-tier company in a chain of foreign affiliates, the current "excluded property" definition requires a taxpayer to first determine the status of the shares of bottom-tier affiliates. The status of the shares of the next higher-tier affiliates is then determined, taking into account the status of the shares of the lower-tier affiliates that it owns. This approach can produce anomalous results.

B.26 If a lower-tier affiliate has excess "investment assets" (more than 10 percent of its total assets), the entire fair market value of the shares of the lower-tier affiliate will be considered a tainted asset for the purpose of determining the excluded property status of the shares of the higher-tier affiliate that owns them. This process is repeated up the chain of affiliates and can cause a top-tier affiliate to fail the excluded property test even if the amount of investment assets held by the affiliate and lower-tier affiliates is not excessive when viewed on a consolidated basis.

B.27 In other situations, a chain of foreign affiliates could have excess investment assets when viewed on a consolidated basis, yet the shares of the top-tier affiliate could still satisfy the excluded-property test because of the bottom-up analysis inherent in the current definition.

B.28 The Panel believes the definition of "excluded property" should be modified to take a more consolidated approach, considering the property of the entire underlying group and not of a single affiliate. In applying the excluded property test at any particular level within a chain of foreign affiliates, the property of all underlying entities should be divided into excluded property and non-excluded property. If the value of the group's excluded property comprises all or substantially all of the total value of the group's property, then the shares of the top affiliate would constitute excluded property. Such group determination could be done on a country-by-country basis.

Temporary excess investment assets

8.29 At times, foreign affiliates will have temporary excess cash or investment assets on hand, possibly arising from the sale of certain business units or from its operations. The presence of such assets can make it difficult to determine whether the shares of the affiliate are excluded property. In some cases, the cash or investment assets may not be excess to the business because they are being held to make a strategic acquisition. For a variety of reasons, such as expected fluctuations in interest rates, it may be preferable to hold such assets rather than retire existing debt.

8.30 From a policy perspective, it seems reasonable that property, such as cash or other short-term investments, that is held for a reasonable time period to fund an acquisition of excluded property should not preclude the shares of the corporation holding the short-term investments from being considered excluded property.[144]

Certification for withholdings under regulations 102 and 105

8.31 In Recommendation 7.3, the Panel calls for Canada to eliminate withholding tax requirements related to services performed and employment functions carried on in Canada where the non-resident certifies the income is exempt from Canadian tax because of a tax treaty. Such a certification system could be implemented as follows:

- To claim a reduced or zero rate of withholding, the non-resident could file a short form with the payer certifying the income is exempt. The certification form would capture data about the non-resident, including business and personal information (such as corporate names, addresses and foreign country tax identification numbers), so the CRA can obtain more information if needed.
- The payer would review the form to assess whether the exemption from withholding is warranted. The payer would reject the form if the payer knew or had reason to know that any of the facts or statements on the form may be false or that the non-resident's exemption from withholding could not be readily determined.
- The payer would file with the CRA an information return reporting the transactions, along with a copy of the certification form.
- Preferably, the non-resident could use its treaty country tax identification number, eliminating its requirement to obtain a Canadian Social Insurance Number, business number or tax identification number; however, this may not be possible in all cases.
- The non-resident would file a tax return at year-end if the amounts paid or payable by all Canadian payers exceeded a specified threshold.

144 A similar position can be considered to have been taken in the proposed rules dealing with FIEs. Under the definition of "exempt property" in those rules, exempt property of a non-resident entity is property of the non-resident entity that is being accumulated (for not more than 36 months or such longer period approved by the Minister of National Revenue) for active business use or for acquiring equity interests in active business entities. Exempt property is treated as not being investment property for the purpose of determining a non-resident entity's classification as a foreign investment entity. A similar provision could apply for FAPI purposes.

Providing investment advisory services to non-residents

B.32 Section 115.2 of the Act specifies the activities a Canadian investment fund manager can undertake on behalf of a non-resident without causing the non-resident to be treated as carrying on business in Canada. The Canadian investment fund manager can offer services in respect of most Canadian securities other than unlisted securities that derive their value principally from Canadian real estate, resource or timber resource property.

B.33 The Panel understands that the carve-out for such securities poses challenges for Canadian investment fund managers competing for mandates from non-residents. At the same time, the Panel recognizes that there may be technical reasons for excluding certain securities and believes that consultation would be required to assess whether further relief should be provided. The same would be true on considering whether relief should extend to related parties and partnerships of which non-residents are members.

Appendix C Taxation of Foreign-source Income — Revisiting the Other Alternatives

C.1 As noted in Chapter 4, broadly speaking, countries have three principal choices in how they tax foreign income earned through foreign entities:

- Accrual or Worldwide Basis of Taxation
- Deferral with Credit (the Credit Method)
- Full Exemption Method

The key elements of these methods were also described in Chapter 4.

C.2 In our consultation paper, the Panel suggested that our consultations and review of Canada's system of outbound taxation should focus on the scope of the exemption for foreign active business income. However, the Panel also considered it important to revisit and assess the relative merit of the alternative methods. The Panel's findings and conclusions in this area are discussed below.

Accrual or Worldwide Basis of Taxation

C.3 If Canada were to adopt the Accrual Method, all foreign-source income earned directly or indirectly through foreign affiliates would be taxable in Canada on a current basis, with a credit given for any applicable foreign tax.

C.4 In theory, this method is attractive for several reasons:

- early advocates of this method considered it to be a necessary element of a progressive taxation system based on a taxpayer's ability to pay,
- the method ensures that domestic and foreign-source income is taxed currently at comparable rates,
- as a practical matter, this method eliminates any need to distinguish between active and passive income, and
- under this method, similarly-situated taxpayers perceive that they are being taxed on an equal basis whether they do business in Canada or abroad, which arguably upholds the morale of taxpayers and induces them to comply with their legal obligation to self-assess their income.[145]

145 See Arthur J. Cockfield, *Examining Policy Options for the Taxation of Outbound Direct Investment* (September 2008), research report prepared for the Advisory Panel on Canada's System of International Taxation, at section 2.3.

C.5 Although many OECD and EU countries employ this system for taxing passive income earned indirectly through certain foreign corporations, none employs this system in its purest sense for taxing foreign business income. New Zealand comes close, but it still maintains exceptions for foreign corporations located in countries included on a grey list. Additionally, following its own consultations, New Zealand recently introduced legislation to move closer to a full exemption system for taxing foreign business income.

C.6 A consultation paper issued by the New Zealand government details the drawbacks of using the Accrual Method for active business income. The Panel found this discussion to be of special interest, given the country's eventual decision to change to a broader exemption system.[146]

C.7 In particular, the New Zealand paper notes that the Accrual Method eliminates the incentive for corporations to invest abroad in favour of investment domestically. Thus, for countries with relatively small domestic economies, the Accrual Method limits opportunities for its domestic companies to grow and compete internationally. The Panel believes these to be compelling arguments that apply equally to Canada.

C.8 Use of the Accrual Method would eliminate a policy feature of Canada's system for taxing foreign business income that actually predates the current foreign affiliate rules, namely, the deferral of Canadian taxation of such income until it is repatriated.

C.9 More importantly, use of the Accrual Method would contradict Canada's outbound taxation policy by putting Canadian businesses operating globally at a major disadvantage with respect to businesses based in all of Canada's major competitors, none of which have adopted this approach.

C.10 For the above reasons, the Panel has concluded that the Accrual Method is not a viable alternative for Canada, except with respect to the taxation of passive income, as discussed more fully starting at paragraph 4.79.

Credit Method

C.11 If Canada were to adopt the Credit Method, the taxation of foreign business income earned indirectly through foreign corporations would be deferred until such income is repatriated to domestic shareholders, and a tax credit would be available to offset the foreign income tax paid on the income.

C.12 The Technical Committee on Business Taxation rejected this approach in 1998, largely because of the enormous complexity inherent in such a system. The Panel agrees that a move by Canada to this alternative would be undesirable.

146 New Zealand, Inland Revenue Department, Policy Advice Division, *New Zealand's International Tax Review: A Direction for Change*, op. cit., at pp. 8-14.

The Panel sees no clear justification for the Credit Method. Conceptually, it is closer to the Accrual Method as it is intended to tax active business income on repatriation subject to credit for underlying foreign tax.[147] However, the ability to defer the taxation of foreign business income under this method indefinitely imparts an exemption element. Under the Credit Method system currently in place in the United States, the exemption element is at least equal to, and in some respects perhaps greater than, that of the Canadian system.[148]

On the other hand, the Credit Method discourages the repatriation of foreign-source income because the income then becomes subject to tax, potentially impeding the ability of home country firms to access capital efficiently so they can compete effectively with others.

The Panel also notes that major countries that employ this method, including the United Kingdom, Japan and the United States,[149] are considering moving to an exemption system for taxing foreign active business income.

For the above reasons, the Panel has concluded that the Credit Method is not a viable alternative for Canada.

147 As is the case where countries employ an exemption system, passive income earned directly or indirectly through certain foreign entities would be taxed under the accrual method.

148 In particular, cross-crediting under the U.S. system effectively allows U.S. corporations to avoid U.S. taxation on certain foreign-source royalties, interest and other passive income earned directly, and U.S. Treasury studies show that a move to exemption would increase taxes.

149 The United Kingdom is more advanced in this regard; the UK government issued a discussion paper in June 2007 stating, among other things, its desire to move to an exemption system as early as 2009. In August 2008, Japan's Ministry of Economy, Trade and Industry published a report entitled "Proposal for Boosting Repatriation of Foreign Subsidiaries' Profits — Towards Introduction of Foreign Dividends Exclusion System" outlining a proposal to move to a dividend exemption system. The proposal was subsequently reflected in the Tax Reform Request for fiscal year 2009. The debate in the United States in recent years has centred on various studies that advocate a change to a full exemption system, including studies by the Joint Committee on Taxation and the 2005 President's Advisory Panel on Federal Tax Reform.

Appendix D Biographical Notes

Peter C. Godsoe, OC, MBA, LL.D., FCA

Peter Godsoe began his career with Scotiabank in 1966 in Ottawa. After serving in Toronto, Montreal and New York, he rose rapidly through various positions and then was elected President and Chief Operating Officer in 1992, Chief Executive Officer in 1993 and Chairman in 1995. Mr. Godsoe retired from the Bank of Nova Scotia on March 2, 2004.

His corporate directorships include Barrick Gold Corporation (since 2004), Ingersoll-Rand Company (since 1998), Lonmin PLC (since 2001), Onex Corporation, (since 2004) and Rogers Communications Inc. (since 2003).

Mr. Godsoe was the Chancellor of the University of Western Ontario from 1996 to 2000 and is currently a Vice Chairman of the Atlantic Institute for Market Studies and a director of a number of non-profit institutes, including the Canadian Council of Christians & Jews, Mount Sinai Hospital and the Perimeter Institute for Theoretical Physics.

Mr. Godsoe holds a B.Sc. in Mathematics and Physics from the University of Toronto. He also holds an MBA from the Harvard Business School and is a CA and a Fellow of the Institute of Chartered Accountants of Ontario. Mr. Godsoe has accepted honorary degrees from the University of King's College, Concordia University, the University of Western Ontario and Dalhousie University. In 2002, Mr. Godsoe became a member of the Canadian Business Hall of Fame and an Officer of the Order of Canada.

Kevin J. Dancey, FCA

Kevin Dancey was appointed President and CEO of the Canadian Institute of Chartered Accountants in June 2006. Prior to his appointment, he served as the CEO and Canadian Senior Partner of PricewaterhouseCoopers from 2001 to 2005. Prior to his election by partners to this position, he served as leader of PricewaterhouseCoopers' Canadian Tax Services group.

Mr. Dancey joined Coopers & Lybrand in 1973, moving to the Tax Group in 1976. He was appointed partner in 1980. Between 1985 and 1987, he served as special adviser to the Department of Finance as part of the Executive Interchange Program and, from 1993 to 1995, he served as Assistant Deputy Minister, Tax Policy Branch of the Department of Finance. In 1995, he was appointed leader of Coopers & Lybrand's Canadian Tax practice, a position he retained after the merger.

In 2006, he was appointed a member of the Auditor General's Panel of Senior Advisors, the Council of Governors for the Canadian Public Accountability Board, the Board of the International Federation of Accountants and the Global Accounting Alliance.

He graduated from McMaster University in 1972 with an Honours Bachelor of Arts degree in Mathematics and Economics. He became a CA in 1975 and was awarded his FCA in 2000. Mr. Dancey has written and spoken extensively on international and business tax issues.

James Barton Love, QC

Mr. Love is a lawyer and founding partner of the Toronto law firm Love & Whalen. He is also Chairman and CEO of Legacy Private Trust, which specializes in wills, estates, trusts and guardianships and focuses its service mandate on being a fiduciary. He has practised in the areas of income tax, commodities tax, acquisitions, mergers, corporate reorganizations, estate planning, wills and trusts, with an emphasis on international tax planning.

Mr. Love's directorships include the Royal Canadian Mint and a number of Canadian corporations. He is also a director of several charitable foundations, including the Bacula Foundation, the Lillian and Don Wright Foundation, and the Westaway Charitable Foundation. He served as Chair of the Expert Panel on Financial Security for Children with Severe Disabilities, which presented its Report to the Minister of Finance in the fall of 2006.

Mr. Love obtained a Bachelor of Laws and a Master of Laws in Taxation Law from Osgoode Hall Law School, Toronto, Ontario. He was appointed Queen's Counsel by Her Majesty the Queen in right of Canada in 1992.

Nicola (Nick) Pantaleo, FCA

Nick Pantaleo is an international tax services partner with PricewaterhouseCoopers LLP and the leader of the firm's Canadian National Technical Services group. He is the former leader of the firm's International Tax Services group and, with over 20 years of experience providing international tax advice to a number of Canada's largest corporations, is recognized as one of Canada's top international tax specialists.

He joined Price Waterhouse in 1980 and was admitted to the partnership in 1991. He holds a Bachelor of Commerce degree from the University of Toronto and became a Fellow Chartered Accountant in 2006. He is a former Adjunct Associate Professor of international tax at the University of Waterloo Master of Taxation program and was a lecturer and the course coordinator at the Canadian Institute of Chartered Accountants Advanced International Tax Course. He is the Vice-President of the Canadian Branch of the International Fiscal Association and has served as a governor of the Canadian Tax Foundation.

Mr. Pantaleo is a regular speaker at business conferences on international taxation matters, including conferences sponsored by the Canadian Tax Foundation, the International Fiscal Association and the Tax Executives Institute. He has written numerous papers on international tax matters and is a former co-editor of the International Tax Planning feature for the Canadian Tax Journal. Mr. Pantaleo is a recipient of the Douglas J. Sherbaniuk Distinguished Writing Award, presented annually by the Canadian Tax Foundation.

Finn Poschmann

Finn Poschmann is Director of Research at the C.D. Howe Institute, where he has held a variety of positions since January 1998. He is program coordinator for the Institute's Financial Services Research Initiative. For more than a decade he was at the Parliamentary Research Branch in Ottawa, where he held a number of research positions providing economic analysis and advice to Parliamentarians and Standing Committees. He has worked in numerous areas within the field of economics, but has primarily been concerned with public finance and taxation and federal-provincial relations.

He is particularly interested in the distributional impact of taxation and in the use of microsimulation tools in the design of tax policy, but has also worked on monetary policy issues and disparate public policy questions. Recent publications have dealt with federal and provincial tax and fiscal issues, taxes and foreign investment, the tax treatment of retirement savings, Canada's exchange rate policies and financial services. Mr. Poschmann is a recipient of the Canadian Tax Foundation's Douglas J. Sherbaniuk Distinguished Writing Award.

Guy Saint-Pierre, CC

Guy Saint-Pierre retired as Chairman of the Board for the Royal Bank of Canada on February 27, 2004, a position he held since his appointment on August 1, 2001. Previously, he had been President and Chief Executive Officer of SNC-Lavalin Group Inc. from January 1989 to May 1996 and Chairman between May 1996 and May 2002.

Mr. Saint-Pierre began his career as an officer in the Corps of Royal Canadian Engineers at Camp Gagetown, New Brunswick in 1959. From 1964 to 1966 he was Registrar of the Corporation of Engineers of Québec, then vice-president of Acres Québec until 1970. He was elected to the National Assembly of Québec in April 1970 and served as Minister of Education (1970-1972) and Minister of Industry and Commerce (1972-1976).

Mr. Saint-Pierre serves on the board of the Institute for Research on Public Policy. Between 1990 and 2007, he served on the Alcan Inc., BCE, Bell, General Motors of Canada, Royal Bank of Canada and SNC-Lavalin Inc. boards. He is past chairman of the Canadian Manufacturers Association, the Conference Board of Canada and the Business Council on National Issues.

Mr. Saint-Pierre graduated from Laval University with a B.A. Sc. in Civil Engineering in 1957. An Athlone Scholar, he obtained an M.Sc. from the University of London in 1959 and holds a D.I.C. from the Imperial College of Science and Technology. He is a Companion of the Order of Canada.

Cathy Williams

Cathy Williams, a graduate of the University of Western Ontario and Queen's University, retired as Chief Financial Officer of Shell Canada Limited in June 2007. She joined the Board of Directors of Enbridge Inc. and was appointed Chair of the Board of Governors of Mount Royal College in Calgary in 2007.

Ms. Williams worked for Shell for 22 years in a variety of financial roles, including two assignments in London, England, with Shell International. Previously she worked for the Federal Business Development Bank in Ottawa, the Bank of Canada in Ottawa and Toronto, and Nova Corporation in Calgary.

Her previous community involvement included membership on the Boards of Directors of Junior Achievement of Southern Alberta and the United Way of Calgary, both of which she chaired. She is also currently on the Advisory Board for the Dean of the Business School at Queen's University.